SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, ~~1964~~ 1965

No. ~~679~~ 23

FRIBOURG NAVIGATION COMPANY, INC.,
PETITIONER,

vs.

COMMISSIONER OF INTERNAL REVENUE.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

INDEX

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[fol. A] [File endorsement omitted]

Appendix to Petitioner's Brief—Filed July 10, 1963

IN THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

No. 28165

FRIBOURG NAVIGATION COMPANY, INC., Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE, Respondent.

ON PETITION TO REVIEW A DECISION OF THE TAX COURT OF THE UNITED STATES

[fol. 1]

STATEMENT UNDER RULE 15(B)

This proceeding was commenced by the filing of a petition in the Tax Court of the United States on July 20, 1960 by Fribourg Navigation Company, Inc. The petitioner sought a redetermination of a deficiency in its income tax for the calendar year 1957, which had been determined by the Commissioner of Internal Revenue as set forth in a Notice of Deficiency mailed on April 27, 1960. The Commissioner's answer to the petition was filed September 14, 1960. Trial was had on June 8, 1962 before the Honorable Marion J. Harron, a judge of the Tax Court of the United States. No question was referred to a commissioner, master or referee. The decision of the Tax Court was entered on December 10, 1962, and it was determined that there was a deficiency in income tax for the calendar year 1957 in the amount of $71,430.97.

The petition of Fribourg Navigation Company, Inc. for review by this Court was filed on March 5, 1963. There have been no changes in the parties.

[fol. 2]

BEFORE THE TAX COURT OF THE UNITED STATES

WASHINGTON

Docket No. 88182

FRIBOURG NAVIGATION COMPANY, INC., Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE, Respondent.

DECISION—December 10, 1962

Pursuant to the determination of the Court, as set forth in its Memorandum Findings of Fact and Opinion filed December 10, 1962, it is

Ordered and decided: That for the taxable year 1957, there is a deficiency in income tax in the amount of $71,430.97.

Enter:

Marion J. Harron, Judge.

[fol. 3]

BEFORE THE TAX COURT OF THE UNITED STATES

Docket No. 88182. Filed December 10, 1962.

FRIBOURG NAVIGATION COMPANY, INC., Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE, Respondent.

T. C. Memo. 1962-290

Held: Claimed depreciation deduction on an asset disallowed for taxable year in which the asset was sold at a price substantially in excess of its undepreciated cost as of

the beginning of the taxable year. *Randolph D. Rouse*, 39 T. C. ...., (October 10, 1962), followed.

James B. Lewis, Esq., and Theodore Ness, Esq., for the petitioner.

Edward H. Hance, Esq., for the respondent.

MEMORANDUM FINDINGS OF FACT AND OPINION—
Filed December 10, 1962

HARRON, *Judge:* The Commissioner determined an income tax deficiency for 1957 in the amount of $71,430.97. The question is whether petitioner is entitled to deduct depreciation of an asset used in its business during most of 1957, which was sold at the end of that year at a profit. The asset was sold for an amount which exceeded its depreciated cost at the beginning of the year. Respondent disallowed depreciation for the last period of use of the asset in the amount of $135,367.24.

[fol. 4]

Findings of Fact

The stipulated facts are found as stipulated and are incorporated herein by this reference.

The petitioner had its principal place of business in New York City. It kept its books and filed its returns on the basis of a calendar year and an accrual method of accounting. Its return was filed with the district director of internal revenue for the District of Lower Manhattan.

Petitioner was organized on February 15, 1946, and was dissolved on January 17, 1958, pursuant to a plan of liquidation adopted in 1957 which came within the provisions of section 337 of the 1954 Code.

During 1957 and before, petitioner's business was the operating of ships, which it owned, in foreign commerce under charters from those having dry, bulk cargoes for shipment. In 1957 petitioner owned and operated two ships, only, the *Flying Foam* and the *Joseph Feuer*. The *Flying Foam* is a CIB type steam turbine, dry cargo vessel, a faster ship of better engine type than the *Feuer*. The *Feuer* is a Liberty-type dry cargo ship. The issue presented relates to the *Feuer*.

The *Feuer* was constructed in 1943 for the United States Maritime Commission for emergency use during World War II. On December 21, 1955, petitioner purchased the *Feuer* from Drytans, Inc., for cash in the amount of $469,000. Petitioner's use of this ship is set forth hereinafter.

Before buying the *Feuer*, petitioner's attorney applied for and received a letter-ruling, dated December 8, 1955, from the Engineering and Valuation branch of the Internal Revenue Service with respect to depreciation of the ship [fol. 5] under the straight line method of depreciation, as follows: Petitioner was advised that the Internal Revenue Service would accept a "useful economic life" of 3 years from the date of acquisition; a salvage value of $54,000, computed on the basis of $5 per dead weight ton for 10,800 tons; and that the cost of $469,000, less the salvage value, should be spread ratably over a period of 3 years from the date of acquisition. The ruling also stated that it should be understood that the cost of the ship would be subject to check by the office of the district director, that the estimated remaining useful life was "subject to such change as subsequent experience may warrant," and that the ruling was not to be construed as an agreement within section 167(d) of the 1954 Code.

Acting in accordance with the ruling, petitioner computed depreciation of the *Feuer* on the basis of $415,000 (cost less salvage value of $54,000) which it spread over a 3-year useful life from December 21, 1955, to December 21, 1958, under the straight line method. This resulted in depreciation at a daily rate of about $378.65 ($378.64963) over a period of 1,096 days. If petitioner had owned and used the ship for 3 years from the date of purchase to December 21, 1958, and if the above ruling with respect to allowable depreciation had not been changed, petitioner would have computed annual depreciation about as follows:

Year	Days of Use	Depreciation
1955	10 days	$ 3,786.50
1956	366 days	138,585.77
1957	366 days	138,585.77
1958	354 days	134,041.96
	1,096 days	$415,000.00

[fol. 6] Petitioner, in fact, claimed a deduction for depreciation of the *Feuer* on the above basis for 10 days in 1955 and all of 1956 in the respective amounts of $3,786.50 and $138,585.77. Upon audit of its returns for those years the depreciation deductions were allowed by the respondent. The total depreciation allowed for 1955 and 1956 amounted to $142,372.27; and the depreciated cost of the *Feuer* at the beginning of 1957 was $326,627.73.

The Internal Revenue Service did not change the ruling of December 8, 1955, relating to useful economic life and salvage value of the *Feuer*.

The Suez Canal in normal times is the busiest interocean canal in the world. Under an international convention made in 1888, the Canal was to be open to all nations. Prior to 1956 a commission composed mostly of British and French nationals directed the management of the Canal. On June 13, 1956, Great Britain ended its 74-year military occupation of the canal area pursuant to an agreement with Egypt. On July 26, 1956, Egypt seized the Canal. Israel invaded Egypt on October 29, 1956, and two days later Great Britain and France attacked Egypt in an effort to restore international control of the Canal. During the hostilities the Canal became blocked by sunken vessels. The fighting was ended on November 7, 1956, by United Nations action. The United Nations sent a police force to maintain peace in the canal area; it aided in salvage operations necessary to clear the canal. The canal was reopened for full-time use on March 29, 1957, under Egyptian management.

Because of the blockages of the Suez Canal, ships had to take the longer routes to places otherwise reached by going through the Canal. There was a resulting scarcity of [fol. 7] available ships to carry cargoes. Also, European governments, anticipating a long delay in the opening of the Canal, began stockpiling oil and other commodities. There were resulting increases in charter rates, which reached a peak in January and February of 1957, and the scarcity of ships caused sales prices of ships to rise sharply. In January and February of 1957, purchasers were willing to pay as much as $1,000,000 for American flag Liberty-type ships.

In June of 1957 the president of Isbrandtsen Company Inc. approached the petitioner about the possible purchase of the *Feuer*, although petitioner had not put the ship up for sale. Like the petitioner, Isbrandtsen Company used Liberty-type ships in its business. Petitioner received the offer of an excellent price for the *Feuer* and for that reason decided to sell the ship, although petitioner had used it in its business for only about 18 months.

On June 14, 1957, petitioner entered into a contract for the sale of the *Feuer* to the Isbrandtsen Company for $700,000, payable $350,000 in cash at the time of the closing; $175,000 six months later, under a 5 percent note; and $175,000 one year later, under a 5 percent note. The contract called for delivery of the ship during December 1957.

As of June 14, 1957, there had been an appreciation in the value of the *Feuer* due to economic and market conditions.

After entering into the contract, Isbrandtsen Company, on the same day, assigned all of its contractual rights to a New York City partnership, Long, Quinn & Boylan Co., which is engaged in the business of acting as a broker for ship owners and persons desiring to charter ships. [fol. 8] Long, Quinn & Boylan did not operate the *Feuer;* they chartered the ship to Isbrandtsen Company.

On December 23, 1957, petitioner delivered the *Feuer* to Long, Quinn & Boylan at Hoboken, New Jersey. On the same day the contract of sale was modified; Long, Quinn & Boylan paid petitioner $695,500 for the ship: $625,000 was paid in cash; $70,000 was to be paid one year later under a 5 percent note.

As of December 23, 1957, petitioner had used the *Feuer* in its business for two years, i.e., one year less than the period of three years, the useful economic life of the ship which was estimated at the time of acquisition in 1955. Petitioner continued to own its other ship, the *Flying Foam*. Petitioner's past experience did not show that it followed a practice of buying and then selling ships after a short period of use.

In its income tax return for 1957, petitioner deducted depreciation of the *Feuer* for 357½ days, the period during which it had used the ship in its business up to the time of delivery to the purchaser. Petitioner deducted $135,367.24 for depreciation which was computed in the same way as for prior periods of use.

The respondent disallowed in full the depreciation deduction. In the statutory deficiency notice the only explanation given for the denial of the deduction was that the petitioner "was not entitled to depreciation * * * under the applicable provisions of the Internal Revenue Code of 1954."

In its return for 1957, petitioner reported gross profit after costs of operations in the amount of $391,811.31, of which amount about $289,340 represented gross profit [fol. 9] from the operation of the *Feuer*. Petitioner reported taxable income, after the depreciation deduction of $135,367.24, in the amount of $141,193.35.

On March 7, 1957, prior to the sale of the *Feuer*, petitioner adopted a plan of complete liquidation to be completed within a period of 12 months. Petitioner carried out the plan within 12 months. All of its assets, less those retained to meet claims, were distributed to its stockholders in redemption of stock, including the proceeds from the sale of the *Feuer*. Since the plan of liquidation came within the scope of section 337, no gain or loss to petitioner was recognized from its sale of the *Feuer* within the 12-month period. For information purposes only petitioner reported the sale of the *Feuer* at a profit in its income tax return for 1957. Petitioner reported gain, after total depreciation of $277,739.51 (including depreciation for 357½ days in 1957 of $135,367.24), in the amount of $504,239.51.

From December 21, 1955, to December 23, 1957, the *Feuer* was operated under the American flag as a tramp ship, without a regular schedule. It was operated under 6 charters carrying either grain, sugar, fertilizer, or scrap iron from the United States to Korea, Japan, Morocco, Egypt, Israel, and India. Return voyages were made with-

out cargoes, but such arrangement did not involve any loss because of foreign aid program payments made by the United States.

At the end of 1957, there were only about 88 Liberty-type ships which were privately owned and operated under the American flag; 70 were operated as tramp ships. Liberty ships have a speed of about 10 knots and a cubic capacity of about 475,000 feet. Modern cargo ships, built [fol. 10] after the war, are superior, having a speed of 14 to 18 knots and cubic capacity of about 600,000 feet. In postwar commerce, Liberty ships carried low-paying bulk commodities, principally grain and coal. After the Suez Canal crisis, tankers built during the crisis began carrying grain in competition with American flag Liberty ships.

By the end of 1957, charter rates had fallen sharply from the high levels they had reached during the Suez crisis. This sharp drop in charter rates resulted from the reopening of the Canal, the diminishing of world tension, the entry into the market of large modern vessels, and the realization by the European governments that they had overstocked commodities.

The above-described movements in charter rates are reflected in the voyage charter fixtures (i.e., contracts for the shipment of goods) published weekly by Maritime Research, Inc. That publication shows the following rates, in dollar per long ton, for voyage charters of American flag Liberty-type ships for the shipment of heavy grain during the last quarter of 1955, the first quarter of 1957 (the peak of the Suez crisis), and the first quarter of 1958:

Trade Route	Oct.-Dec. 1955		Jan.-Mar. 1957		Jan.-Mar. 1958	
U. S. Gulf—Piraeus	High	18.00	High	20.85		14.50
	Low	16.50	Low	19.00		
North Pacific—Korea	High	17.00	High	18.50	High	13.00
	Low	16.35	Low	18.43	Low	11.00
North Pacific—Formosa		15.85	High	20.25		13.00
			Low	18.50		

Charter rates for American flag Liberty-type ships were substantially lower during the last two quarters of 1957 [fol. 11] than they had been during the second quarter of that year when the petitioner had contracted to sell the *Feuer*. This is reflected in the following rates published by Maritime Research, Inc. for voyage charters of such ships for the shipment of heavy grain or barley (the rate for which is slightly higher than the rate for heavy grain):

Trade Route	Apr.-June 1957		July-Sept. 1957		Oct.-Dec. 1957	
S. Gulf—Haifa		19.25		14.00	High	15.00
					Low	14.25
rth Pacific—Korea	High	14.75 (barley)	High	13.20	High	11.50 (barley)
	Low	14.00 (barley)	Low	11.50	Low	11.25
th Pacific—Japan	High	13.75		10.85	High	10.75
	Low	13.35			Low	10.35
th Atlantic—Poland		13.85		12.00	High	13.25
					Low	12.80

By the last quarter of 1957, when petitioner delivered the *Feuer* to its new owner, charter rates for American flag Liberty-type ships were significantly lower than they had been in the last quarter of 1955 when petitioner had purchased the *Feuer*. This is reflected in the following comparison of rates published by Maritime Research, Inc. for voyage charters of such ships for the shipment of heavy grain or barley:

Trade Route	Oct.-Dec. 1955		Oct.-Dec. 1957	
U. S. Gulf—Haifa		19.00	High	15.00
			Low	14.25
North Pacific—Korea	High	17.00	High	11.50 (barley)
	Low	16.35	Low	11.25
U. S. Gulf—Karachi	High	24.95		21.10
	Low	23.40		
North Pacific—Formosa		15.85		13.00

[fol. 12] During the Suez crisis, the United States government encouraged independent owners to build tankers by providing them with extensive financing guarantees. An owner was able to build a tanker with only 12½ percent cash, with the balance payable over 20 years and guaranteed by the Government. During 1957 19 independently owned American flag tankers ranging in dead weight tonnage from 26,500 tons to 67,000 tons were contracted for or under construction. These 19 tankers had a total dead weight tonnage of 731,273 tons, which about equals the total dead weight tonnage (approximately 700,000 to 800,000 tons) of the 70 or so Liberty-type ships trading as tramp vessels under the American flag. These tankers had a speed of about 15½ to 16 knots, much faster than the Liberty-type ships. During the Suez crisis, when these tankers were ordered, the charter rates for oil were high and remunerative. However, by the end of 1957 this was no longer true, and the surplus American flag tankers had begun to carry grain.

The American flag tankers, having greater tonnage and speed, were able to carry grain at lower rates than American flag Liberty-type ships. The rates, in dollars per long ton, published by Maritime Research, Inc. for voyage charters of American flag tankers and American flag Liberty-type ships for the shipment of heavy grain for the same week and same trade route are compared below:

Trade Route	Week Ending	Tanker Rate	Liberty-type Ship Rate(s)
U.S. Gulf—Poland	Sept. 14, 1957	12.50	13.40; 13.50
U.S. Gulf—Trieste	Nov. 2, 1957	13.50	15.35
U.S. Gulf—Karachi	Feb. 2, 1958	17.85	24.25
U.S. Gulf—Turkey	Apr. 4, 1958	11.95	15.50

[fol. 13] By the end of 1957, the business of shipping coal, which had been one of the two principal commodities carried by American flag Liberty-type ships, had about disappeared because of the world-wide increase in oil consumption.

By December of 1957, when the petitioner delivered the *Feuer* to the purchaser, prices for such ships had fallen to the level of from $400,000 to $500,000.

On December 13, 1957, the United States Maritime Administration sold 9 Liberty-type ships for scrapping under a previously extended invitation for bids. Eight of these 9 vessels were sold at prices ranging from $83,000 to $90,388.88. The ninth vessel was sold for $141,241.41, a price attributed by an experienced engineer to an uninformed bid.

The price obtainable for Liberty-type ships for scrapping is determined principally by reference to the price of No. 1 scrap steel, and the cost of preparation, towing, insurance, and other costs of scrapping. A buyer for scrapping is influenced by the estimated future of the scrap steel market because of the time required to prepare and sell the scrap steel. In December of 1957, scrap steel prices were falling. The amount which a buyer could be expected to offer for a Liberty-type ship for scrapping at that time was between $53,000 and $60,000.

[fol. 14]

Opinion

The question is whether under section 167 of the 1954 Code any depreciation deduction is allowable for the period in 1957 during which petitioner used the *Feuer* in its business.

The respondent's position is that since the depreciated cost of the *Feuer* at the beginning of 1957 was less than the amount realized upon sale, there is no basis for allowing a deduction for depreciation for 1957; or, stated differently, that since petitioner recovered before the end of 1957 more than the amount of the depreciated cost at the start of the year, a deduction for depreciation in 1957 is not allowable. Respondent relies on *Cohn* v. *United States*, 259 F. 2d 371 (C. A. 6, 1958); Rev. Rul. 62-92, 1962-1 C. B. 29;[1] *Massey Motors, Inc.* v. *United States*, 364 U. S. 92

[1] The provision in section 1.167(a)-1(c) of the regulations to the effect that salvage value shall not be changed at any time after

[fol. 15] (1960); and *Hertz Corporation* v. *United States*, 364 U. S. 122 (1960).

In his statutory deficiency notice, the respondent failed to state specifically the reason for his determination. His argument here, however, makes it clear that upon auditing petitioner's 1957 return his inquiry was whether a deduction of $135,367.24 for 1957 for depreciation of the *Feuer* was reasonable; he took the view that the reasonableness of the claimed deduction for depreciation depended upon the conditions and facts known to exist at the end of 1957; and he concluded that the fact that the asset, having an undepreciated cost of $326,627.73 at the start of 1957, was

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the determination made at the time of acquisition merely because of changes in price levels applies to assets still on hand. The provision does not preclude adjustment of salvage value where there is a clear and convincing basis therefor even though no adjustment of useful life is required. The purpose of the provision is to eliminate needless and endless controversies over depreciation allowances which at best are merely informed estimates of the cost of using the property in the taxpayer's business. That purpose has been served when the asset is disposed of and when a final transaction has occurred over which there can be no dispute or difference of opinion or judgment. These rules are and have always been applicable to the allowance of the deduction for depreciation. See *Massey Motors, Inc.* v. *United States* and *Commissioner* v. *Robley H. Evans, et ux*, 364 U. S. 92 (1960), Ct. D. 1847, C. B. 1960-2, 445; and *Hertz Corporation* v. *United States*, 364 U. S. 122 (1960), Ct. D. 1848, C. B. 1960-2, 70.

Accordingly, it is the position of the Service that the *Cohn* case [*Cohn* v. *United States*, 359 F. 2d 371 (C. A. 6, 1958)] applies equally to the 1939 Code and the 1954 Code and that it is not only reasonable but proper to take the ultimate facts into consideration in determining the depreciation deduction for the year of disposition of the asset. Therefore, the deduction for depreciation of an asset used in the trade or business or in the production of income shall be adjusted in the year of disposition so that the deduction, otherwise properly allowable for such year under the taxpayer's method of accounting for depreciation, is limited to the amount, if any, by which the adjusted basis of the property at the beginning of such year exceeds the amount realized from sale or exchange. See also section 1.167(a)-10 of the regulations for rules with respect to when depreciation is allowable.

* * * * * * *

sold before the end of the year for $695,500, made unreasonable any deduction for depreciation for the year of the sale.

Section 167(a) of the Code provides that there shall be allowed as a depreciation deduction a reasonable allowance for the exhaustion, wear and tear of property used in a business; and section 167(b) provides that for taxable years ending after December 31, 1953, "the term 'reasonable allowance' shall include (but shall not be limited to) an allowance computed in accordance with regulations prescribed by the Secretary or his delegate, * * * ." The pertinent sections of the Commissioner's Regulations are sections 1.167(a)-1 (a), (b), (c), and 1.167(b)-0. It is not necessary to set forth in their entirety the provisions [fol. 16] of the applicable Regulations other than to state the following:

> 1. * * * The reasonableness of any claim for depreciation shall be determined upon the basis of conditions known to exist at the end of the period for which the return is made. It is the responsibility of the taxpayer to establish the reasonableness of the deduction for depreciation claimed. * * * (Section 1.167(b)-0.)
>
> 2. * * * Salvage value must be taken into account in determining the depreciation deduction either by a reduction in the amount subject to depreciation or by a reduction in the rate of depreciation, but in no event shall an asset (or an account) be depreciated below a reasonable salvage value. * * * (Section 1.167(a)-1(c).)

The petitioner had the burden of proving that the claimed depreciation deduction represents a reasonable allowance under section 167 of the Code. The dispute relates only to the year in which the asset was sold. Petitioner takes the position that it is reasonable to allow a deduction for depreciation for the wear and tear sustained from the *use* of the asset in its business during the taxable year up to the time of delivery to the buyer in December 1957; that granting a reasonable allowance for depreciation through

use is a matter which is separate from computing the gain realized from a bona fide sale; and that respondent's determination involves circuitous reasoning in equating the amount received in a bona fide sale with salvage value with respect to the proposition that an asset shall not be depreciated below its salvage value, under the facts and circumstances of this case in which petitioner, with the advice and consent of the Internal Revenue Service, made [fol. 17] allegedly reasonable estimates just before the time of the acquisition of the *Feuer* of both the useful life in its business of the ship, and of salvage value. In attempting to meet its burden of proof, petitioner presented extensive evidence in support of its original estimate of salvage value in the amount of $54,000. That evidence establishes that due to declining prices of ships, charter rates, and scrap steel toward the end of December 1957, some Liberty-type ships were being sold for scrap at prices between $53,000 and $60,000 at the end of 1957.

Respondent has not questioned petitioner's original estimate of a 3-year useful life of the *Feuer* in its business.

The record does not show that in petitioner's past experience it followed a practice of using ships for a short time and then reselling them. Thus, it cannot be said that it was petitioner's policy "to dispose of assets which are still in good operating condition," in which case "the salvage value may represent a relatively large proportion of the original basis of the asset." See section 1.167(a)-1(c) of the Regulations relating to salvage value.

Petitioner contends that this case is distinguishable from those where the taxpayer did not make any estimate of salvage value when acquiring an asset and left salvage value at zero; and argues that it is to be observed that the Commissioner's resort to resale price as evidence of salvage value in the year of sale probably may be explained by the fact that in those instances the taxpayers had computed their annual depreciation deductions on the basis of an estimated useful life without any estimated salvage value. Cf.

Evans v. *Commissioner*, 264 F. 2d 502, 504, reversed 364 U. S. 92; *Cohn* v. *United States, supra*, pp. 374, 375; *United* [fol. 18] *States* v. *Massey Motors*, 264 U. S. 552, 554, affd. 364 U. S. 92; *Randolph D. Rouse*, 39 T. C. (October 10, 1962).

Petitioner relies primarily upon early authorities, decided before *Massey Motors, Inc.* v. *United States, supra*, and related cases, in which depreciation allowances were allowed in the year of sale and depreciation was regarded as separate from the computation of the adjusted basis of property, and the gain or loss resulting from a sale was arrived at by use of cost depreciated up to the time of sale and sale price. These authorities include the following: *United States* v. *Ludey*, 274 U. S. 295 (1927); *Even Realty Co.*, 1 B. T. A. 355 (1925); *Capital City Investment Co.*, 4 B. T. A. 933 (1926); *Max Eichenberg*, 16 B. T. A. 1368 (1929); *Herbert Simons*, 19 B. T. A. 711, 713-714 (1930); *Thos. Goggan & Bro.*, 45 B. T. A. 218 (1941); and the decision of the issue in *Wier Long Leaf Lumber Co.*, 9 T. C. 990, 999 (1947), affd. and revd. on other issues, 173 F. 2d 549 (C. A. 5, 1949), dealing with depreciation of automobiles (p. 999).

It was stated in the *Ludey* case that the theory underlying the allowance for depreciation is that by using up an asset in a business "a gradual sale is made of it" and the depreciation charged is the measure of the cost of the part which has been "sold" through the use of the asset. Petitioner contends that the "formula" of the *Ludey* case is the keystone of the respondent's depreciation regulations and that his regulations have attempted to stabilize depreciation allowances by "strictly limiting the circumstances under which the useful life and salvage value determined at the time of acquisition of the asset may be changed". Petitioner relies upon the provisions in section 1.167(a)- [fol. 19] 1(b) and (c) which provide that "estimated remaining useful life shall be redetermined only when the change in the useful life is significant" and when "there is a clear and convincing basis for the redetermination"; and that salvage value "shall not be changed at any time after

the determination made at the time of acquisition merely because of changes in price levels." The only circumstance in which the regulations authorize redetermination of salvage value is in connection with redetermination of useful life, in which case "salvage value may be redetermined based upon facts known at the time of such redetermination of useful life."

Petitioner argues that respondent's determination violates the concept which he has adopted in his long-standing regulations that useful life and salvage value are interrelated terms, and that respondent, in attempting to equate sales price to salvage value in every circumstance, has failed to recognize the vital "difference between a dead plant and a live one." *Omaha* v. *Omaha Water Co.,* 218 U. S. 180, 202 (1910).

Petitioner agrees with respondent that an asset may not be depreciated below a reasonable salvage value, but asserts that resale price is not always the measure and equivalent of salvage value. Petitioner argues that "if the taxpayer decides to sell an asset while it is still alive and productive in his business, he is realizing something other than salvage value." Petitioner's contentions emphasize the point that the *Feuer* was sold before the end of its useful life in its business, was not fully depreciated at the time of sale, and fetched a high price when sold because of extraneous economic conditions. In these circumstances, [fol. 20] argues petitioner, respondent should be held to what appears to have been established rules, as follows: (1) "[T]hat in computing the gain from the sale of property a deduction of depreciation during the period of operation shall be made." *Rieck* v. *Heiner,* 25 F. 2d 453, 454, (C. A. 3, 1928), certiorari denied 277 U. S. 608, following *United States* v. *Ludey, supra; Herbert Simons, supra; Duncan-Homer Realty Co.,* 6 B. T. A. 730, 732. (2) "[M]ere appreciation in value due to extraneous causes has no influence on the depreciation allowance, one way or the other. * * * The sole fact therefore in any specific situation that a given price is received for articles not fully

depreciated throws no light on the effect upon the depreciation allowance. * * * The depreciation deduction cannot be disallowed merely by reason of the price received for the article without the consideration of other factors." *Wier Long Leaf Lumber Co., supra,* p. 999.

Petitioner's argument and the authorities relied upon have been fully considered. But the concept of depreciation for tax purposes is rather complex, and changes in economic conditions have brought about new considerations by the courts of the old, well established rules relating to depreciation allowances in the light of the rising market prices of used assets and the corresponding realization of large gains upon the resale of such used assets. For example: The Supreme Court in the cases of *Massey Motors, Inc.,* and *Hertz Corporation* has taken into account the "formula" of the *Ludey* case but it has emphasized the statutory objective of achieving "an accurate determination of the net income from operations of a given business for a fiscal period", and it has clarified the meaning of [fol. 21] "salvage value" by recognizing that under present market conditions "salvage value" must include resale or second-hand value. Thus, in *Massey Motors,* the Supreme Court expressed the view that the Congress "intended that the taxpayer should, under the allowance for depreciation, recover only the cost of the asset less the estimated salvage, resale or second-hand value. This requires that the useful life of the asset be related to the period for which it may reasonably be expected to be employed in the taxpayer's business. Likewise, salvage value must include estimated resale or second-hand value." Also, in *Hertz Corporation* (although dealing with the declining balance system of depreciation), the Supreme Court indicated that it does not comport with the overriding statutory requirement that the depreciation deduction be a *reasonable* allowance, to allow depreciation deductions "beyond what reasonably appears to be the price that will be received when the asset is retired." The facts and circumstances in the authorities on which the petitioner relies must be regarded as distinguishable from the facts and circumstances

of this case when considered in the light of the Supreme Court's reasoning in the *Massey Motors* and *Hertz* cases, recently decided.

This Court in *Randolph D. Rouse, supra,* has indicated the above understanding in its holding that a depreciation deduction is not allowable for the year in which an asset is sold where the sale price of such asset is in excess of the asset's undepreciated cost as of the beginning of the year of the sale. In so holding, it was regarded as determinative that the excess of the sale price over and above the remaining undepreciated cost at the beginning of the year of the sale was substantial. That fact is present in this case. [fol. 22] Also, this Court in the *Rouse* case followed the reasoning in *Cohn* v. *United States, supra,* on which respondent relies. The facts here do not provide the distinction which is required in order not to arrive at the same result as this Court reached in the *Rouse* case. This is observed with full recognition of the point that Rouse at no time made any estimate of the salvage value of the assets involved. In *Massey Motors, Inc.,* also, the taxpayer had not made estimates of salvage values of assets. It is the force of the reasoning about the statutory requirement that to be deductible, depreciation allowances must be reasonable, contained in the opinions of the courts in the *Cohn* and *Massey Motors* cases, and the interpretation of the term "salvage value" as including resale or second-hand value, which compels the conclusion reached by this Court in the *Rouse* case.

Under all of the circumstances, it is necessary to recognize the *Rouse* case as dispositive of the question presented in this case. We are unable to find that in reasoning and principle, there is a valid distinction between the *Rouse* case and this one. It follows that the respondent properly determined that the claimed depreciation deduction for 1957 is not allowable under section 167; the respondent's determination is sustained.

Decision will be entered for the respondent.

[fol. 23]

BEFORE THE TAX COURT OF THE UNITED STATES

No. 88182

FRIBOURG NAVIGATION COMPANY, INC., Petitioner,

—against—

COMMISSIONER OF INTERNAL REVENUE, Respondent.

STIPULATION OF FACTS—June 4, 1962

It is hereby stipulated and agreed by and between the respective parties hereto, by their respective counsel, that for the purposes of this case the facts herein stated shall be taken as true, provided, however, that the parties reserve any objection as to materiality or relevance, and that this stipulation shall be without prejudice to the right of either party to introduce upon the trial of this case any other and further evidence not at variance with the facts herein stated.

1. Petitioner, Fribourg Navigation Company, Inc., was incorporated under the laws of the State of Delaware in 1947. Its name was changed from Arrow Barge Company, Inc. to Fribourg Navigation Company, Inc. on January 25, 1957. Petitioner was dissolved on January 17, 1958.

[fol. 24] 2. Throughout its existence, petitioner kept its books and filed its income tax returns on the basis of the calendar year and the accrual method of accounting. It filed its income tax return for the calendar year 1957 with the District Director of Internal Revenue for the District of Lower Manhattan within the time required by law. A copy of such return is annexed hereto as Exhibit 1-A. Petitioner's principal office during 1957 was at 26 Broadway, New York, N. Y.

3. Respondent has determined a deficiency of $71,430.97 in petitioner's 1957 income tax liability.

4. The only determination at issue is respondent's disallowance of a deduction of $135,367.24 claimed by petitioner for depreciation of the SS Joseph Feuer (hereinafter "the vessel"). The vessel was a Liberty-type dry cargo ship (type Liberty EC2-SC1; official number 243521) constructed during 1943 at the North Carolina Shipbuilding Yard for the United States Maritime Commission for emergency use during World War II. Its name at the time of its purchase by petitioner was SS Albion (Ex Polarus Sailor).

5. During the calendar year 1957 and for some time prior thereto petitioner was engaged in the ownership and operation of ships for charter in foreign commerce as carriers of grain or other bulk commodities. During the calendar year 1957 petitioner so owned and operated the vessel and one other ship. Petitioner operated them as tramp ships, *i.e.*, for charter wherever freight was offered [fol. 25] and without a regular or established schedule. Petitioner operated the vessel under the American flag with Wilmington, Delaware as its home port.

6. Petitioner had purchased the vessel on December 21, 1955, from Drytans, Inc. for $469,000 in cash. Drytans, Inc. was not related to petitioner through stock ownership or otherwise.

7. Petitioner operated the vessel under the following charters:

(a) From December 21, 1955 to July 12, 1956, under three voyage charters for the carrying of commodities from the United States to foreign ports:

From	To	Commodity	Duration of Charter
Longview, Wash.	Japan	Scrap	Dec. 21, 1955-March 11, 1956
Longview, Wash.	Haifa, Israel	Grain	Mar. 12, 1956-June 2, 1956
Boston, Mass.	Alexandria, Egypt	Grain	June 3, 1956-July 12, 1956

(b) From July 12, 1956 to April 3, 1957, under time charter to States Marine Corporation.

(c) From April 4, 1957 to December 23, 1957, under three voyage charters for the carrying of commodities from the United States or Cuba to foreign ports:

From	To	Commodity	Duration of Charter
Baltimore, Md.	Korea	Fertilizer	April 4, 1957-June 30, 1957
Los Angeles, Cal.	India	Grain	June 21, 1957-Oct. 8, 1957
Cardenas, Cuba	Casablanca, Morocco	Sugar	Oct. 9, 1957-Dec. 8, 1957

[fol. 26] 8. On June 4, 1957, petitioner entered into a contract for the sale of the vessel to Isbrandtsen Company, Inc. for $700,000, payable $350,000 in cash, $175,000 in the form of a 5 percent note due six months after the closing, and $175,000 in the form of a 5 percent note due one year after the closing. On the same date Isbrandtsen Company, Inc. assigned its rights under the contract to Long, Quinn & Boylan Co., a partnership.

9. The contract of sale provided for delivery of the vessel at a United States Gulf or Atlantic port at petitioner's option between December 1 and December 31, 1957. A copy of the contract is annexed hereto as Exhibit 2-B. Pursuant to the contract, petitioner delivered the vessel to Long, Quinn & Boylan Co. at Hoboken, New Jersey, on December 23, 1957. At the closing the contract was amended to adjust the sales price to $695,500, payable $625,500 in cash and $70,000 in the form of a 5 percent note due one year after the closing. A copy of the amendment of the contract is annexed hereto as Exhibit 3-C.

10. Neither Isbrandtsen Company, Inc. nor Long, Quinn & Boylan Co. was related to petitioner through stock ownership or otherwise.

11. The Office of the Commissioner of Internal Revenue issued a letter dated December 8, 1955 (signed by R. C. Staebner, Chief, Engineering and Valuation Branch, Special Technical Services Division) to Anthony N. Zock, attorney for petitioner, with respect to the useful life and salvage value of the vessel. This letter stated that the Internal Revenue Service would accept a useful economic life of three years from the date of contemplated acqui- [fol. 27] sition of the vessel, and that the cost of $469,000 less salvage value computed at $5.00 per dead weight ton should be spread ratably over such three years. A copy of such letter is annexed hereto as Exhibit 4-D.

12. In computing depreciation deductions for the vessel, petitioner set up a salvage value of $54,000 based on a dead weight tonnage of 10,800 tons at $5.00 per ton. Petitioner computed depreciation on the vessel by spreading the cost of $469,000 less such salvage value, or $415,000, over a useful life of 1096 days, or at the rate of $378.64963 per day under the straight line method of depreciation. Petitioner claimed the following depreciation deductions at such rate and under such method on its income tax returns:

Calendar year	Period of ownership	Depreciation claimed
1955	10 days	$ 3,786.50
1956	366 days	138,585.77
1957	357½ days	135,367.24

13. The dead weight tonnage of the vessel (*i.e.,* its total carrying capacity, expressed in long tons) was 10,800 tons. Its gross tonnage was 7255 tons and its net tonnage 4461 tons.

14. Petitioner's 1955, 1956 and 1957 returns were audited by the Internal Revenue Service. The deductions claimed for depreciation of the vessel on the 1955 and 1956 returns were accepted by the Service without adjustment. The deduction claimed for depreciation of the vessel on the 1957 return was wholly disallowed.

15. The adjusted basis of the vessel as of the beginning of 1957 was $326,627.73.

[fol. 28] 16. The Suez Canal is, in normal times, the busiest interocean canal in the world. In 1888, an international convention agreed that the canal should be open to all nations. For many years prior to 1956 a commission composed mostly of British and French nationals directed management of the canal. On June 13, 1956, Great Britain, pursuant to a 1954 agreement with Egypt, ended its 74-year military occupation of the canal area. On July 26, 1956, Egypt seized the canal over the protest of Great Britain, France and other Western nations. Israel invaded Egypt on October 29, 1956, and Great Britain and France attacked Egypt two days later in an effort to restore international control of the canal. During the hostilities the canal became blocked by sunken vessels. The fighting was ended by United Nations action on November 7, 1956. The United Nations sent a police force to maintain peace in the canal area and also aided in the salvage operations necessary to clear the canal. The canal was reopened for fulltime use on March 29, 1957, under Egyptian management.

Dated: June 4, 1962.

James B. Lewis, Counsel for Petitioner; Theodore Ness, Counsel for Petitioner; Crane C. Hauser, Chief Counsel, Internal Revenue Service.

[fol. 29]

EXHIBIT 4-D TO STIPULATION OF FACTS

[Letterhead of]

U. S. TREASURY DEPARTMENT
WASHINGTON 25

T:S:EP:JHF

Mr. Anthony N. Zock
Zock & Petrie
52 Broadway
New York 4, New York

In re: Arrow Barge Company, Inc.
2 Broadway, New York, N. Y.
SS ALBION (EX POLARUS SAILOR)

Dear Mr. Zock:

This is in reply to your letter of November 29, 1955 in which you request a determination on behalf of your client, Arrow Barge Company, Inc., that the remaining useful economic life of the Liberty-type dry cargo vessel SS ALBION (EX POLARUS SAILOR), which is described in your letters of October 15 and 27, 1955 in the case of Arrow Steamship Company, Inc., will not extend for more than three years beyond the contemplated date of purchase, December 15, 1955, and that the salvage value at that time will not exceed $5.00 per dead weight ton.

You state, "It is now contemplated that Arrow Steamship Company, Inc. assign its contract of purchase with Drytrans, Inc. to its affiliate, Arrow Barge Company, Inc. with all other terms and conditions remaining unaltered except that delivery and Bill of Sale be made to Arrow Barge Company, Inc."

[fol. 30] After consideration of the information furnished in your letter of November 29, 1955 as well as the information furnished in your letters of October 15 and 27, 1955

in the case of Arrow Steamship Company, Inc., including the affidavit of Mr. Harry A. Sperling, Executive Vice President, you are advised that the Internal Revenue Service will accept a useful economic life of three (3) years from the date of contemplated acquisition (December 15, 1955) for the Liberty-type dry cargo vessel, SS Albion (Ex Polarus Sailor). The cost of $469,000.00 at date of acquisition, less salvage value computed at $5.00 per dead weight ton, shall be spread ratably over a period of three (3) years from date of contemplated acquisition, i.e., December 15, 1955.

It is understood that the cost of the vessel is subject to check by the office of the District Director of Internal Revenue and the estimated remaining useful life is subject to such change as subsequent experience may warrant.

This determination is not to be construed as an agreement within the meaning of section 167(d) of the Internal Revenue Code of 1954.

Taxpayer should be requested to attach a copy of this letter to the return in which this permission becomes effective. Two copies of this letter are enclosed for the taxpayer.

Very truly yours,

R. C. Staebner
Chief, Engineering and Valuation Branch
Special Technical Services Division

Enclosures
2 copies of this letter

[fol. 31]

BEFORE THE TAX COURT OF THE UNITED STATES

Transcript of Hearing—June 8, 1962 (Excerpts)

IRVING LILLIANTHAL was called as a witness on behalf of the petitioner and, being first duly sworn, testified as follows:

* * * * * * *

Direct examination.

By Mr. Lewis:

Q. Mr. Lillianthal, will you state your business?

A. I am the president of Maritime Research, which is an organization which publishes a weekly newsletter detailing all charter fixtures, world wide.

Q. Will you tell the Court what a charter fixture is?

A. A contract between a shipper and a ship owner for carriage of goods.

Q. What information does your publication distribute as to charter fixtures?

A. It lists the names of the vessels, by nationalities, ports of loading and discharging, dates of availability, and their rates.

Q. Does it show the terms at which the shipment is carried?

A. Yes.

Q. What are those terms as a rule?

A. Well, there are various terms, depending upon who will pay for the loading, the discharging and length and number of voyages, things of that nature.

* * * * * * *

Q. Mr. Lillianthal, does this weekly newsletter contain information as to the amounts that American flag liberty ships receive for shipments?

A. Yes, it includes both American flag vessels and foreign flag vessels.

* * * * * * *

[fol. 32] Q. I show you this schedule and ask you if you have seen it before?

A. Yes, I have.

Q. Did you supervise its preparation?

A. I supervised and checked the information contained herein.

Q. Was the information compiled from your weekly newsletter?

A. Yes, it was.

Q. Will you describe the information contained in the schedule?

A. These are the rates paid—

The Court: Would you like that marked for identification, please?

The Clerk: Exhibit 6 for identification.

(The document referred to was marked Petitioner's Exhibit 6 for identification.)

By Mr. Lewis:

Q. Will you describe the information contained herein?

A. These are the rates paid to American flag liberty type vessels by quarters on certain trade routes for the years 1955 through 1958. That's just the last quarter of 1955.

Q. You mean calendar quarters?

A. Yes.

Q. For the carrying of what commodity?

A. These are all heavy grain shipments. There are some barley shipments included here which are specifically marked. The rate for barley is slightly higher than the rate for heavy grain.

Q. Where there is more than one shipment during a calendar quarter does the schedule show that information?

A. We have shown a high and low for each calendar quarter, so that it would include any shipments which fall between those values, those rates.

[fol. 33] Q. What trade routes have been selected for this purpose?

A. Well, any trade route which shows a fair amount of activity. And we have chosen ten or more weeks in this period to show that. We have included that in this.

Q. By ten or more weeks you mean the number of weeks which there were reports for that trade route?

A. Yes.

* * * * * * *

Q. Did liberty ships operate under a fixed schedule?

A. No, liberty ships, tramp ships being perhaps a better word, don't follow a set schedule.

Q. What kind of voyage does a fixture call for a liberty ship to make, as a rule?

A. Actually, it's what we call a tramp voyage. In other words, there is no set pattern for those vessels. They go wherever cargo calls, or wherever they can get cargo.

Q. Do these fixtures call for a direct shipment of a cargo from one single port to a single port of destination?

A. Yes, these fixtures listed in this particular report show these cargo vessels from one port of loading to one port of discharge.

The Court: Is that what you mean by trade route?

The Witness: Yes.

Q. Will you again state the basis on which the trade routes listed on this schedule were selected?

A. Well, we have tried here to, rather than bring in a bulky report for every American fixture, we have combined these fixtures to show the trade routes which have [fol. 34] the greatest number of activity so we can have a comparison over this entire year. Consequently, what we have done is chosen trade routes where there are ten or more contracts in each one of these quarters. That way we can have a continuity of information over this entire period.

* * * * * * *

By Mr. Hance:

Q. Mr. Lillianthal, what is the source of your information that you have compiled here into this table?

A. Our weekly publication—the information gathered in that publication is obtained from U. S. Government sources from the various brokers, ship owners, charterers, etc.

Q. Do you check this information as to reliability, or anything?

A. Yes, every fixture is checked and double-checked; and, incidentally, from time to time whenever an error does occur a correction is made.

Q. You have "H" and "L" besides these things. Is that high and low?

A. Yes.

Q. What are the figures that have no designation besides them?

A. There are no charter fixtures reported in that period for that trade route in that period.

* * * * * * *

By Mr. Hance:

Q. Can you explain the fact that the price went down and then apparently goes back up again between 1957-1958?

A. Well, there are various reasons why the market goes up and down. I guess the same reasons would hold true in the stock market. Actually, it's a question of supply and demand, normally. During the Suez crisis, of course, you had an artificial situation there.

[fol. 35] The Court: What year was that?

The Witness: That, I believe, was the end of 1956, or early 1957.

* * * * * * *

Harry Sperling was called as a witness on behalf of the petitioner and, being first duly sworn, testified as follows:

*   *   *   *   *   *   *

Direct examination.

By Mr. Lewis:

Q. Mr. Sperling, in what field of business activity are you engaged?

A. Steamship operating, and owning.

Q. How long have you been engaged in that?

A. For over 25 years.

Q. During the years 1955 to 1957 were you an officer of the petitioner in this case, Fribourg Navigation Company?

A. Yes.

Q. What was your office?

A. Executive vice president.

Q. What were your duties in connection with that office?

A. I managed the affairs of the company, chief executive officer.

Q. What ships did the company own during this period?

A. The Joseph Feuer, and also the Flying Foam.

Q. Can you briefly describe each ship?

A. The Joseph Feuer is a liberty vessel. The Flying Foam was a C1A.

Q. What is a C1A?

A. A C1A is a smaller ship and a faster one than the liberty types.

Q. To what use did the company put its ships during these years?

A. The Flying Foam was out on a five-year charter, and the Joseph Feuer, wherever cargo presented itself, on a voyage-to-voyage basis.

[fol. 36] Q. What were your duties in connection with the chartering of the vessels? What decisions did you make?

A. The decisions—when to charter the vessel, and at what rates, too.

Q. In connection with the purchase of these ships, were you engaged in the negotiations?

A. Yes.

Q. When did you open negotiations for the purchase of the Joseph Feuer?

A. I would say about a week or ten days prior to its actual purchase.

Q. At that time did you apply to the attorney for the company, or did you authorize the attorney for the company to apply to the Internal Revenue Service for a depreciation ruling?

A. I did.

Q. Late in 1955, when the company acquired the Joseph Feuer, did you have an opinion as to the period for which that ship could continue to be profitably operated?

A. No.

Q. Were you familiar at that time with the operating conditions of liberty ships?

A. Yes.

Q. For what depreciation over what period did you authorize application to be made to the Internal Revenue Service?

A. Three years.

Q. What kind of cargoes were available to the Joseph Feuer?

A. Only government aid cargoes, mainly under Public Law 480.

Q. Could the Joseph Feuer compete with foreign vessels for cargoes in world commerce generally?

A. Absolutely not.

Q. Why not?

A. Because the operation of an American flag vessel prohibited competing with foreign flag vessels, the cost.

[fol. 37] Q. Was the company able to transfer the Joseph Feuer to a foreign flag?

A. No, sir.

Q. Why not?

A. The law prohibited that.

Q. Could the Joseph Feuer obtain return cargoes to the U. S. after it had completed its foreign aid shipments?

A. No.

Q. Did it ever obtain such return cargo?

A. No.

Q. Why could it not do so?

A. The rates were too low to permit an American flag vessel to operate profitably.

Q. Did you handle the negotiations for—

The Court: The rates were too low. What do you mean by that? The rates that would be paid by a foreign shipper?

The Witness: That's right.

The Court: Would you make that clearer?

The Witness: Well, under Public Law 480 there is a 50-50 provision where shippers are required to ship 50 percent on American flag bottoms and the other 50 percent on foreign flag bottoms. The government, in this case the Department of Agriculture, pays the difference between the American flag rate and the foreign flag rate and absorbs that in the form of subsidy.

The Court: That is, in those cases where shipments are made on foreign flag vessels, is that correct?

The Witness: No, where they are made on American flag vessels the rate is generally much higher, and the government pays that difference.

By Mr. Lewis:

Q. In connection with what kind of shipments does the government make such provisions?

A. P.L. 480 grain shipments, Foreign Aid.

[fol. 38] Q. Any other types of shipments?

A. Well, some other commodities, if it's under the P.L. 480 program.

The Court: What is Public Law 480?

The Witness: The law enacted for the disposal of farm surpluses abroad.

The Court: Now, who pays, if you ship farm surpluses to Lebanon, for that shipment?

The Witness: Well, if it is under Public Law 480, the Lebanese would pay for it, but in local currency.

The Court: And they pay at this low rate, or foreign rate, or something like that?

The Witness: They pay the foreign rate, and the government absorbs the difference between the foreign rate and the American flag rate.

The Court: What fixes the American flag rate?

The Witness: Supply and demand. There's a market every day.

The Court: So you, as the operator of a liberty ship, charge for a shipment to Lebanon of a United States farm surplus the current market rate?

The Witness: For American flag vessels, yes.

The Court: I guess you would call them consignees?

The Witness: Yes, consignees or receivers.

The Court: They pay at the foreign rate, and then you make a charge to the Department of Agriculture, probably fill in some forms and ask to have a differential paid by the government, is that correct?

The Witness: Well, the form—you are quite correct that there is such a form, but it is usually made out by [fol. 39] the receiver, the recipient government; they make that form and get that differential, and its own bookkeeping as far as the foreign government is concerned, and—

The Court: It eventually gets to you?

The Witness: We will get the full American rate, but the adjustment is made between governments.

The Court: All right.

By Mr. Lewis:

Q. Are you familiar with the difference in levels between the American and foreign rate?

A. Yes, sir.

Q. Could you state, as of December, 1957, approximately what percentage of the American rate the foreign rate was?

A. I would say that the American rate was probably at least double that of the foreign rate, but I would have to refer to some statistics to know.

Q. And the American rate was available for what kind of shipments?

A. The American flag vessels, the tramp vessels, the only cargoes available were government aid cargoes.

Q. And if the Joseph Feuer were to have taken a cargo from its foreign points of destination back to the United States, then what rate would it have gotten?

A. It would have had to take the foreign flag rate.

Q. Could it operate profitably under the foreign flag rates?

A. No, sir.

Q. Did you handle the negotiations for the sale of the Joseph Feuer?

A. Yes.

[fol. 40] Q. With whom did you conduct those negotiations?

A. Those negotiations were conducted with Jakob Isbrandtsen.

The Court: Do we have that in the stipulation?

Mr. Hance: It's in Paragraph 8, your Honor, I believe.

* * * * * * *

Q. Which party opened the negotiations?

A. Mr. Isbrandtsen.

Q. When did you decide to sell the Joseph Feuer?

A. A few days after we started negotiations.

Q. Why did you decide to sell it?

A. We thought it was an excellent price.

The Court: Did they come to you or did you go to them?

The Witness: In this particular case they came to me.

Mr. Lewis: I have no further questions.

Cross examination.

By Mr. Lewis:

Q. Mr. Sperling, when did you purchase this CIA that you referred to as being one of the ships that you owned?

A. I believe in 1953.

Q. And you purchased the Joseph Feuer in 1955, is that correct?

A. That's correct.

Q. Why did you purchase these vessels?

A. We thought it was reasonable business.

Q. Well, weren't you aware of all these factors you have testified to at the time you purchased them regarding rates and differentials between foreign and American and so forth?

A. Yes.

[fol. 41] Q. The question I am not clear on, you testified that the vessels here, when they are chartered, you cannot get a return charter, is that it?

A. A return cargo.

Q. Well, we show in our stipulation in Paragraph 7, for instance, that the ship was chartered December of 1955—March of 1956, and then the next charter begins one day later, March of 1956. Now, is this the correct duration of this charter, up to March 11, 1956, the first one?

A. Yes.

Q. Does the charter then cover the return trip? Both of these were from the same place?

A. The charter calls for the movement of a particular commodity from point of loading to point of discharge, and that's the number of days it actually took for the vessel to go to its destination, discharge and come back again, in ballast.

Q. Then this is not the duration of the charter, then?

A. That is the duration of the charter.

The Court: The duration of the charter includes the return trip, is what he is saying.

Mr. Hance: I thought he testified that he couldn't get a return charter on the ship.

The Witness: That's correct: it came back in ballast.

Colloquy

By Mr. Hance:

Q. But you were paid for the return trip, right?

The Court: Well, what does that mean?

A. We were paid, yes.

The Court: Well, your contract calls for, in this particular instance, taking metal scrap, I suppose it is, from [fol. 42] Longview, Washington, to Japan. You understood, apparently, when you made this contract that your ship would come back empty, except for ballast?

The Witness: That's right.

The Court: Now, in fixing the charge for the shipment, and this is done under market terms, according to the market, what do you charge when you are going to send a ship to a port with cargo and bring it back empty except for ballast?

The Witness: Well, of course, the rates that you obtain for a particular cargo is a matter of supply and demand, and there is a market for it every day.

The Court: Well, we want to get that right there. There is such a thing as a rate for a cargo?

The Witness: Yes.

The Court: And what you are going to charge here is a rate for charging a cargo of scrap?

The Witness: Which, in each case, is negotiated with the charterer, and I think you will find in that Maritime Research the various fixtures every day, or over a given period, and they have a range. Now, when we calculate as to what voyage we would like to take, or do, the ballast voyage is always calculated as a cost item, so in fact even the Maritime Commission's own bookkeeping setup stipulates that a voyage on their vessels is a complete round trip, come back in ballast. That's the government's own accounting setup, which we follow.

[fol. 43] The Court: Does that clear that up, Mr. Hance?

Mr. Hance: I think so, your Honor.

By Mr. Hance:

Q. Mr. Sperling, did that first charter come under this public law you referred to, this scrap?

A. No.

Q. Do you know whether this public law is still in existence?

A. Yes, sir, it's still in existence.

Q. I wonder do you know how long Mr. Isbrandtsen has been president of Isbrandtsen Company?

A. From May 13, 1953.

Q. Could you tell the Court the business of the Isbrandtsen Company?

A. Isbrandtsen Company is a large American steamship company.

Q. You mean they are owners?

A. Owners, and presently are in control of the American Export Lines.

Q. What use would Isbrandtsen have for a vessel such as the Joseph Feuer?

A. I have no idea.

Q. Well, do they operate these vessels? Would they operate such a vessel?

A. They have operated vessels of that type.

Q. When you were negotiating with them, then, you didn't know why they wanted to purchase it?

A. No.

Q. Do they charter these vessels to third parties?

A. I don't know what they did with them. I would have to go over the records to answer that.

Q. Well, you are familiar with the nature of their business, right?

A. Yes.

Q. And you say they owned this type of vessel, freighter?

A. Yes.

Q. But you don't know whether they operate them [fol. 44] themselves or put them out on charter as you do?

A. I presume they would do the same as we would.

Mr. Hance: That is all, your Honor.

The Court: Going back to Paragraph 7 of the stipulation, Paragraph 7(a), it is my understanding that the parties are agreed that the charters referred to there in—there are three charters—beginning in December of 1955 and going to July 12th of 1956, and in each instance the liberty type ship involved here came back with an empty bottom, is that correct?

The Witness: That's right. Came back without any cargo at all.

Mr. Lewis: Well, that is not stipulated, but I gather it is correct, from the testimony, your Honor.

The Court: No, that is not stipulated. I am asking you if counsel are agreed now that that is a fact.

Mr. Hance: I believe that is what Mr. Sperling testified to.

The Court: Well, you understand that in that way, do you?

Mr. Hance: Yes, your Honor.

* * * * * * *

Mr. Lewis: Well, earlier the Court had inquired as to a breakdown of the operating income on the 1957 return, between that of the Joseph Feuer and of the second vessel, the Flying Foam. I can put an additional witness on for a minute to supply that information.

The Court: All right.

Mr. Lewis: Mr. Saul Binderoff, please.

[fol. 45] Solomon Binderoff was called as a witness for the petitioner and, being first duly sworn, testified as follows:

* * * * * * *

Direct examination.

By Mr. Lewis:

Q. Mr. Binderoff, what is your occupation?

A. Presently?

* * * * * * *

Q. Well, in 1957. I was chief accountant for Fribourg Navigation.

* * * * * * *

Q. I show you Joint Exhibit 1A. Can you state from this exhibit the total operating income reported before deductions for salaries and depreciation?

A. Yes.

Q. What is that amount?

A. On Page 2, Line 15, where it indicates total income, the breakdown is that the Joseph Feuer would show—

Q. Would you give the figure on the line, please?

A. It shows $391,811.31.

Q. How does that breakdown between the two vessels?

A. The Joseph Feuer showed $289,411.31. The Flying Foam showed $102,400.

* * * * * * *

ANTHONY ZOCK was called as a witness on behalf of the petitioner and, being first duly sworn, testified as follows:

* * * * * * *

[fol. 46] Direct examination.

By Mr. Lewis:

Q. Mr. Zock, are you admitted to the practice of law in New York?

A. I am.

Q. How long have you been admitted?

A. About 22 years.

Q. During the years 1953 to 1957 did you perform legal work for the petitioner in this case?

A. Yes, we did.

Q. In 1955 did you apply to the Internal Revenue Service for a ruling on the depreciation of the Joseph Feuer?

A. Yes.

Q. Had you applied for similar rulings for this and other clients in the past?

A. Yes.

Q. Is the representation of steamship owners and operators a substantial part of your practice?

A. It is.

Q. And was it during the years 1953 to 1957?

A. It was then and is now.

Q. As part of your legal practice have you kept informed as to the ruling policies and practices of the Internal Revenue Service with respect to ship depreciation?

A. Yes.

Q. In the summer of 1955 did you inform Mr. Sperling as to the then practice of the Internal Revenue Service with respect to liberty ship depreciation?

A. He consulted me on that and I so informed him.

Q. What was that practice?

A. With respect to liberty ships at that time it was the practice to grant rulings of a similarity to the one that we obtained—three years.

Q. Were those rulings based on useful economic life?

A. Yes.

Q. And what salvage value did those rulings provide?

A. Five dollars.

Q. What does "five dollars" mean?

A. Five dollars per dead-weight ton.

* * * * * * *

[fol. 47] Q. This was the salvage value that had been provided in earlier rulings before you applied in this case?

A. It was.

Q. And the three-year economic life had been also provided by the earlier rulings?

A. Yes.

Q. Did you obtain a ruling in 1955 for this petitioner as to depreciation of the Flying Foam?

A. I did.

Q. What ruling did you obtain in that case?

A. The Flying Foam was not a liberty type vessel. It was a C-1 type vessel, and the ruling which we ultimately obtained was one which was calculated on the basis of a 20-year life from the date of construction. Approximately eleven years from the date of the acquisition of the vessel. We had applied for a seven-year life from the date of acquisition, but the ruling provided for an eleven-year life.

Q. Was this expressed in terms of useful economic life?

A. Yes, it was, and salvage value.

Q. Do you have that ruling?

A. I don't have the ruling on that. I believe Mr. Binderoff has that.

The Court: While counsel is looking for that document, tell me what you mean by C-1 type?

The Witness: That was a designation given to vessels constructed of that type by the Maritime Administration during the war. It was a war-built type of vessel, but it was of a smaller design, better engine type, and it had different characteristics than the liberty ship.

The Court: It was a cargo vessel, though?

The Witness: Yes, a dry cargo vessel.

[fol. 48] By Mr. Lewis:

Q. I show you this document and ask you if this is a photostatic copy of the ruling you obtained on the matter of the Flying Foam.

A. Yes, it is.

Mr. Lewis: May I have this marked for identification?

The Clerk: Exhibit 7 for identification.

* * * * * * *

Q. Will you read from the second paragraph thereof?

* * * * * * *

A. "After consideration of the information furnished in your letters and office conferences on September 16th and 21, 1953, and the affidavit of Harry S. Sperling, you are advised that the Internal Revenue Service cannot accept a seven-year life from date of purchase, but will accept a useful life of 20 years from date of construction termination, October 10, 1946, for the C-1B type steam turbine dry cargo vessel, the Flying Foam. The cost of date of acquisition, expected to be October 10, 1953, less salvage value, computed at five dollars per dead-weight ton shall be spread over the period ending October 10, 1946."

Q. And this was eleven years from the date of acquisition?

A. Yes.

Q. Will you go back to the statement of useful life, the statement that the Service will accept, and read that.

A. "But will accept a useful life of 20 years from date of construction."

Q. I asked you earlier whether this letter was based on useful economic life. Would you care to reply to that again?

A. I guess it was, as stated, the useful life of the vessel.

* * * * * * *

[fol. 49] COLLOQUY

The Court: Is there a difference between useful economic life and useful life in the vernacular, Mr. Lewis? Under the regulations what is the expression used?

Mr. Lewis: The regulations do not use the expression "useful economic life."

The Court: What expression does the regulation use?

Mr. Lewis: "Useful life."

The Court: What about the statute?

Mr. Lewis: It provides for a reasonable allowance for depreciation, and then states parenthetically, including allowance for obsolescence.

The Court: What are you getting at now? The expression that you use and refer to now, have several times what is the expression you are using?

Mr. Lewis: The expression "useful economic life" appears in the ruling issued on the liberty ship.

The Court: For purposes of this present examination in Exhibit 7 for identification the words "useful economic life" are not used.

Mr. Lewis: No, "useful life" is used in connection with the remaining eleven-year life, but "useful economic life" is used with reference to the three-year life remaining with reference to the liberty ship.

The Court: And you are contending that the expression is—

Mr. Lewis: Mean different things, your Honor.

The Court: Now, with respect to obsolescence, what is the point you are getting at there?

[fol. 50] Mr. Lewis: The Commissioner's regulations make it clear that obsolescence may be based on economic factors. Petitioner will hope to demonstrate that the eco

nomic outlook did confirm the short economic useful life the Commissioner ruled for liberty ships and—

The Court: You are going to take the position that the expression "useful economic life" comprises depreciation and obsolescence?

Mr. Lewis: Yes, or where obsolescence exceeds depreciation, your Honor, it simply supplants it, and absorbs it. We will present evidence to show the obsolescence of these vessels, and we contend that in issuing the 1955 ruling the Commission recognized that obsolescence allowances were appropriate for these vessels, by allowing only a three-year life and referring to the economic life.

The Court: All right. Do you have any other questions?

Mr. Lewis: No further questions.

Cross examination.

By Mr. Hance:

Q. Mr. Zock, when did you first obtain a ruling with respect to a liberty type vessel for a client?

A. I am not sure of the exact date. It was somewhere around 1949, I believe.

Q. What useful life were you requesting at that time?

A. Three years.

Mr. Hance: That is all, your Honor.

The Court: And that was in connection with a C-1—

[fol. 51] The Witness: No, in connection with another liberty type vessel for another client.

The Court: Mr. Hance, you asked this witness if he had ever gotten a different ruling—

Mr. Hance: No, the first time he requested a ruling on a liberty type vessel for a client.

The Court: And it was in 1959 and he got a ruling and in that ruling—

Mr. Hance: He requested—

The Court: And was allowed a three-year what?

The Witness: Useful economic life.

The Court: That was the expression used?

The Witness: Yes.

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Walter Leibundgut was called as a witness on behalf of the petitioner and, being first duly sworn, testified as follows:

* * * * * * *

Direct examination.

By Mr. Lewis:

Q. What is your occupation?
A. I am engaged in the steamship business.
Q. How long have you been engaged in that business?
A. About 25 years.
Q. Were you an officer of the petitioner in this case, Fribourg Navigation Company?
A. Yes.
Q. In 1955 and 1957?
A. I was.
Q. What office?
A. Vice president.
Q. Would you describe your official duties?
A. I was in charge of chartering and operating details, under the direction of Mr. Harry Sperling.
[fol. 52] Q. In connection with the chartering of a vessel did you compute operating costs?
A. I did.
Q. In what manner did you make these computations?
A. Well, we would calculate the voyage, or the anticipated voyage, in order to decide which voyage was most profitable.
Q. What factors did you take into account?
A. We took the cost of the vessel, cost of fuel, port charges and stevedoring and all miscellaneous items pertaining to cost of operation, plus anticipated revenue.

Mr. Lewis: May I have this document marked for identification?
The Clerk: Exhibit 8 for identification.

(The document referred to was marked Petitioner's Exhibit 8 for identification.)

By Mr. Lewis:

Q. I show you this schedule and ask you if you are familiar with it.

A. Yes, I am.

Q. Can you describe the information on it?

A. Well, this is information compiled in our office that concerns the actual cost of operating an American flag liberty ship. We have wages, including overtime and vacation, pension and welfare fund of $868. We have subsistence charges of $59, deck engineer and stewards' supply, $63, maintenance seven dollars, repairs $218, and insurance, including deductibles, $113, miscellaneous, $19, making a total of $1347 per diem.

Q. That is the daily cost of operating the vessel?

A. Yes.

Q. As of what period was this compiled?

A. 1957.

[fol. 53] Q. To what vessel did the figures relate?

A. To the SS Joseph Feuer.

Mr. Lewis: I offer this in evidence.

Mr. Hance: No objection, your Honor.

The Court: Received as Exhibit 8.

(The document heretofore marked Petitioner's Exhibit 8 for identification was received in evidence.)

Mr. Lewis: I would like these documents marked for identification.

The Clerk: These are Exhibits 9, 10 and 11 for identification.

(The documents referred to were marked Petitioner's Exhibits 9 through 11 for identification.)

By Mr. Lewis:

Q. Mr. Liebundgut, I show you three voyage estimates and ask you if you prepared these.

A. Yes, I did.

Q. Will you explain the computation on the estimates?

A. Surely.

Q. Take No. 9 first and describe that.

A. No. 9 is an estimate made for voyage starting in Galveston, Texas for a cargo of wheat to be loaded in Galveston and discharged in Haifa. It's a normal calculation that was made prior to our taking any particular cargo, and on it we calculate, number one, the number of tons of cargo we expect to lift. We then take this quantity and extend it by the freight rate and this particular case it's $15, making a gross revenue of $149,175. [fol. 54] and deduct commission of two and a half percent, making that revenue $145,446.

We then calculate how long we expect it to take to load and to grain-fit the vessel and we have allowed seven days. We divide the speed of the vessel into the miles of the voyage and we find we take 29 days to get to Haifa. We have allowed four days to return.

Discharge, 29 days to return and a normal allowance of spare seven days, making 76 days total voyage at the cost of $1347, or total cost of $102,372.

We have allowed bunkers calculated at the rate of 25 tons per day at sea and five tons per day at port, or a total of 1505 tons at the then cost rate of $32,735.

Q. What is a bunker?

A. Fuel oil consumed by the vessel. We then charged this calculation with the port charges both at Galveston and Haifa, as we know them to be, as well as charging stevedoring, loading and the necessary expenses for fitting the vessel and our normal spare, and we found the cost was $148,857, making a net loss for the round voyage of $3411.

Q. Does Exhibit 10 relate to a different voyage?

A. Yes, it does. Exhibit 10 is a calculation made from Galveston, Texas to Poland.

Q. Made in the same manner as Exhibit 9?

A. In exactly the same fashion.

Q. What net result does it show?

A. A profit of $1500.

Q. And Exhibit No. 11?

A. Exhibit 11 is again of cargo being loaded in Galveston of bulk wheat destined for Karachi and here we show a loss of $5636.

Q. Were the various elements of cost you used in making these estimates based on the costs of the SS. Joseph Feuer in the latter part of 1957?

A. Yes, they were.

[fol. 55] Q. On what are the projected revenue from the voyage based?

A. The revenues were based on the rates that were actually chartered during this period.

Q. Were these actual voyages of one of your liberty ships? Do these cover actual voyages by an actual ship?

A. No, it does not.

Q. But they are projections based on charter rates and expenses as of the close of 1957?

A. That's correct.

Mr. Lewis: I offer Exhibits 9, 10 and 11 in evidence, your Honor.

Mr. Hance: No objection, your Honor.

The Court: They are received in evidence.

(The documents heretofore marked Petitioner's Exhibits 9 through 11 for identification were received in evidence.)

Mr. Lewis: Your witness.

Cross examination.

By Mr. Hance:

Q. Mr. Leibundgut, when did you prepare those estimates?

A. These were made a few days ago.

Q. Did you include in those estimates any cost for depreciation?

A. No, sir.

* * * * * * *

Mack Klosky was called as a witness on behalf of the petitioner and, being first duly sworn, testified as follows:

* * * * * * *

[fol. 56] Direct examination.

By Mr. Lewis:

Q. Mr. Klosky, in what business are you engaged?

A. In the chartering/brokerage business.

Q. How long have you been in that business?

A. In this particular field of the business, 14 years.

Q. What was your business before that?

A. Well, in 1936 I was vice president of a steamship company engaged in the owning and operation of vessels and running of berth liners.

The Court: What was the name of the company?

The Witness: T. J. Stevenson & Co., Inc., originally doing business under the name of Bulk Carriers Corporation and subsequently became T. J. Stevenson.

By Mr. Lewis:

Q. Will you describe your present activities in the chartering of vessels?

A. Well, we are cargo brokers, and we represent chiefly grain exporters, commercial grain exporters, and we are the exclusive representatives of several foreign governments, and our office is engaged in the chartering of vessels in world-wide transportation of bulk commodities.

Q. Have your activities made you familiar with the operation of liberty ships and their chartering, American flag liberty ships?

A. Yes, sir.

Q. In 1957 can you tell the Court how the speed of a liberty ship compared with that of a more modern post-war vessel?

A. Well, perhaps I can best answer that by saying that the speed of liberty ships has really never changed since

[fol. 57] the day they were launched. They were constructed for 9½ to 10-knot speeds, and the average liberty ship today is still cruising at about ten knots, and the modern cargo tramp ship of today, of recent construction, is anywhere from 14 to 18 knots.

* * * * * * *

The Court: Well, what is there about a liberty ship that puts it in a class by itself? You have mentioned, one, that they were constructed for not more than 10-knot speed. Now, that has to do with the boilers or engines on the ship, I suppose.

The Witness: Well, if you will recall, your Honor, during the war we had this tremendously accelerated construction program. We launched a ship a day at every yard in the country, and they put out what was called the EC-2. The liberty ship is known as the EC-2. They were constructed practically on identical dead weights with slight variations in construction, depending on what shipyard they were, west coast or east coast or Gulf port, for the purpose of getting cargoes as quickly as they could to the other side.

The Court: They were made of steel, though?

The Witness: They were steel and welded ships, although in one or two yards they occasionally used some riveting to a minor extent. But because they were welded they broke up later.

By Mr. Lewis:

Q. How do the engines compare with modern ships?

A. Well, the liberty ships were constructed of Scotch [fol. 58] boiler type, consuming fuel oil and having three main boilers and a single propeller and their top speed was about 10½ knots. The new ships today are superheated turbines, high-pressure systems, and there is just no comparison.

Q. How do the two compare as to cargo handling and storage facilities?

A. There is no comparison in that either. The liberty ship has a cubic bail space of approximately 475,000 feet for a vessel described as about 10,500 tons dead weight, meaning her total carrying capacity of cargo, fuel, stores, water and special fittings and everything. Whereas today a modern 10,000-ton ship of the same dead weight will have a cubic capacity of 600,000 feet. In other words, they will carry much more cargo at a much faster rate of speed and carry it more efficiently and load it faster and discharge faster.

Q. What types of cargoes were American flag liberty ships capable of handling?

A. Well, they handled everything during the war, from tanks and landing barges to bulk commodities. That is what they were designed for, to carry everything as a war-time expedient. Not that they did the job well.

Q. What did they carry in post-war commerce under private ownership?

A. Well, they gradually drifted down to the low-paying bulk commodities—grain, sulphur, potash, coal, scrap iron.

Q. What was the principal commodity carried?

A. Coal and grain.

Q. Was the American flag liberty ship facing competition in the carriage of grain by the end of 1957?

A. Yes, they are facing it today, too.

[fol. 59] Q. What was the nature of that competition?

A. Well, the competition has varied in recent years. First—

The Court: Well, we are concerned now with the end of 1957.

The Witness: Well, in 1957 the tankers, vessels which had been primarily designed and intended for the transportation of bulk oil, entered into the bulk dry cargo field, and they began taking grain at sharply reduced rates.

Q. You have mentioned coal as the second important commodity. Were any factors developing as to shipments of coal by the end of 1957?

A. Well, the coal business has just about disappeared with the world-wide increase in oil consumption, so coal no longer became the backbone of the market. Grain did.

Mr. Lewis: May I have Exhibit 6, please.

(Exhibit handed to Mr. Lewis.)

Q. Mr. Klosky, are you familiar with the charter rates in effect for shipment of heavy grain on American flag liberty ships during the years 1955, 1956 and 1957?

A. Yes.

Q. May I show you this chart to refresh your recollection (handing to witness). How did the charter rates in effect that were being obtained for such vessels in December of 1957 compare with those obtainable in the summer of 1957?

A. In December of 1957 and the summer of 1957?

Q. Yes, comparing December of 1957 with six months earlier.

A. Well, there was a sharp drop. The peak was coincidental with Suez, and thereafter it continued to drop [fol. 60] year after year, so specifically answering your question, December of 1957 was lower than the summer months of that year.

Q. Can you furnish an example of the spread?

A. Well, yes. Here is a case where in June of 1957 U.S. Gulf to Haifa paid $19.25 a ton, and in the same year, December, it paid $15 a ton, or a drop of $4.25 a ton.

Q. How did the rates in December of 1957 compare with those of two years earlier when the petitioner had purchased the Joseph Feuer?

A. December 1957 back to December of 1955?

Q. Yes.

A. Again, 1957, December, was considerably higher than the rates prevailing in December of 1955.

Q. What reasons do you ascribe to the sharp drop in rates between December of 1955 and the close of 1957?

Mr. Hance: I didn't understand the question, your Honor.

Mr. Lewis: The petitioner testified in answer to the question before the last one that rates, charter rates, at which American flag liberties, could be had in December of 1957 were far below those in June of 1957, and I have asked him for his opinion as to the reasons for that drop.

A. Well, it was a combination of the diminishing of the world tension, the entry into the market of large modern vessels, and the entry into the market of tankers which carried twice the amount of grain that a liberty ship could carry, at less money.

Q. Are you familiar with the operation of liberty ships by the various companies for whom you fix charters?

A. Yes, I believe so.

[fol. 61] Q. Can you tell us the purpose for which the Isbrandtsen Company was using its liberty ships in 1957?

A. Well, I would say almost exclusively in the tramp field to carry grain and grant-in-aid cargoes, and perhaps occasionally, if they ever got into trouble in a certain position, they might put one in to supplement their liner fleet. But basically for tramping.

Q. Was this the same purpose the petitioner used Joseph Feuer for?

A. Yes.

* * * * * * *

Robert Pierot was called as a witness for the petitioner and, being first duly sworn, testified as follows:

* * * * * * *

Direct examination.

By Mr. Lewis:

Q. Mr. Pierot, what is your business?

A. I'm a broker for the sale and purchase of ships.

Q. With what company?

A. Jack Pierot, Jr., & Sons.

Q. Are you an officer?

A. I am a partner of that company.

Q. How many years have you been associated with the company?

A. A little over ten years.

Q. Does your business require you to keep informed as to the volume of ship construction from time to time?

A. It does.

Q. In your business do you arrange contracts for the construction of ships?

A. I do.

Q. And what other types of contracts do you participate in?

A. We arrange for sale and purchase of secondhand [fol. 62] ships, of new vessels, and the general line of our business also includes appraising, and we generally keep a record of vessels that are available for sale, and of course, of potential buyers.

Q. In the conduct of your business do you keep and maintain records of ships ordered for construction?

A. Yes, I do.

Q. Can you state the approximate tonnage of American flag tanker construction on order as of December 31, 1957?

Mr. Hance: Your Honor, I object to the question. He is inquiring as to the tonnage of tankers.

Mr. Lewis: On order.

Mr. Hance: Well, I don't think the size of the tanker fleet or anything is relevant to this case.

Mr. Lewis: Your Honor, the preceding witness has testified that the tankers were invading the dry cargo grain market and were undercutting liberties.

The Court: Objection is overruled.

A. Yes, I have a record of the independently owned tankers on order in 1957. I say independently because I do not keep a record of the ships ordered by the oil companies, which generally do not come on the market for sale until ten, fifteen years later.

Mr. Lewis: I would like this document marked for identification.

(The document referred to was marked Petitioner's Exhibit 12 for identification.)

By Mr. Lewis:

Q. Did you prepare this list from your business records?

A. Yes.

[fol. 63] Q. Will you describe that?

A. It's a list which states the names, year of completion, and dead weight tonnage of the independently owned tankers under construction, or contracted for, during 1957. It shows a total dead weight tonnage of 731,273 tons.

Q. Do you have any opinion as to how this compares with the tonnage of the America flag liberty ship at that time?

A. Well, contrary to what the preceding witness just said, my records show that in the tramp fleet at the end of 1957 approximately 70 liberties were trading under American flag.

Q. What tonnage would that represent?

A. That would represent a total tonnage of approximately 700,000 tons, plus a fraction, maybe 800,000 tons, with a speed of approximately ten knots; while here we have 731,000 tons with a speed of approximately 15½ to 16 knots.

Q. Was this an unusual level of tanker construction?

A. Yes.

Q. What had led to it?

A. During the Suez crisis the United States Government encouraged independent owners to build tankers by providing for them extensive financing guarantees. An owner was able to build a tanker with only 12½ percent cash, and the balance to be paid over 20 years, and that balance would be guaranteed by the United States Government. The United States Government felt that during Suez there would be a requirement for modern tankers, which, unfortunately for the market, has proved wrong.

Q. Did this create a surplus of tankers for the carriage of oil?

A. Yes, this became apparent, I think, during the last [fol. 64] quarter of 1957, or even before that. See, when

these tankers were ordered the rates that these tankers could obtain for carrying oil were quite high and remunerative, while during the end of 1957 these rates had already gone to a point where an owner could not make any money and could not make his payments on some of these ships.

Q. To what use were the tankers being put by the end of 1957?

A. By the end of 1957 there were quite a few tankers engaged in grain trade, surplus tankers which could find no business in the oil trade would carry grain.

Mr. Lewis: I offer this paper in evidence.

Mr. Hance: No objection.

The Court: Exhibit 12 is received.

(The document heretofore marked Petitioner's Exhibit 12 for identification was received in evidence.)

By Mr. Lewis:

Q. Mr. Pierot, you stated you were familiar with the prices at which secondhand ships sell.

A. Yes.

Q. The parties in this case have testified that the Joseph Feuer was contracted to be sold in June of 1957 for $700,000. Is this representative of liberty ship prices at that time?

A. Yes, it is.

Q. How does this compare with liberty ship prices in December of the same year?

A. In December of that year liberty ships were sold at four and five hundred thousand dollars.

Q. To what cause do you attribute the drop in prices?

A. The inability of a liberty vessel to make any money, and its trading activities.

[fol. 65] Q. And to what do you attribute the $700,000 price level in June of 1957?

A. Pure optimism. Let's say I think I can elaborate on that a little bit more. During Suez the prices for liberty ships, say in January of 1957, would have reached, if such ships were available for sale with prompt delivery, probably about a million dollars. In the shipping business as

in all other markets, without too much success, we tried to maintain an orderly market, and it comes down gradually. Say the 700,000 was the mid-point between the million dollars and $500,00 at the end of the year.

Mr. Lewis: Thank you. No further questions.

* * * * * * *

Cross examination.

By Mr. Hance:

Q. Mr. Pierot, when you are speaking of tankers, are you referring just to American flag vessels?

A. Yes, I am.

Q. These new ones that you referred to that were under construction—generally, what was the size of these ships?

A. They ranged in size from—the smallest was 28,000 tons, approximately and the largest was about 67,000 tons.

Q. And who, what companies, were building these ships?

A. Private tramp owners, I can give you—these are all independent owners, and most of them were also running other dry cargo vessels, but few of them had tankers before, and the only reason they built the tankers was that the government was giving such generous guarantees for the loans.

Q. You say it was connected with the Suez crisis?

A. Yes.

Q. Was that because of the demand for tankers to bring oil from the Middle East? Is that correct?

A. Yes, that's correct.

[fol. 66] Q. Mr. Pierot, you estimated that there are about 70 vessels in the American fleet as of the end of 1957?

A. Privately owned tramping fleet, yes.

Q. Well, I just wonder. The Commerce Department advised me that there were 88 of these vessels plus about four that had been converted to bulk carriers. Would you have any idea why the difference in your figures?

A. I think I qualified privately owned vessels in the tramping market. There are some liberties which are engaged in special trades, for example, the Alaska Steamship Company, which is not necessarily considered in the

tramping business because they have a scheduled run to Alaska. I think the Bull Line is not considered in the tramping trade because they have a scheduled run to Puerto Rico, and I think this will account for the 18 liberties.

Mr. Hance: I see. Thank you very much.

Colloquy

The Court: Will you refresh our recollection about the period of the Suez Canal crisis?

The Witness: Well, in the shipping market when we speak about the crisis, I think we would be referring to January of 1957, because that was the height of the market. Of course, the Suez Canal blockage was much before that.

The Court: What happened to the market in January of 1957?

The Witness: It was at its peak.

The Court: Which market, the shipping—

The Witness: The rates for shipping, and also the prices of ships. That would be January and February of 1957.

[fol. 67] The Court: Well, the political crisis began when?

The Witness: I think it was October, November, 1956.

The Court: And the political crisis provided a stimulus to the building of ships, is that right?

The Witness: Well, partly yes, but not quite. It was also the blockage of the Suez Canal, which necessitated a much longer trip for tankers to carry oil to the Persian Gulf or the United States or the United Kingdom and the European continent.

The Court: So those engaged in the shipping business were making more money because the ships had to take longer trips?

The Witness: Yes, but not just because the ships had to take longer trips. But there was a scarcity of available tonnage to move cargo, which scarcity, of course, drives up the freight rates. The saying in the shipping business is 100 ships and 101 cargos makes good rates.

The Court: The fact that they had to take longer trips also created a scarcity of ships?

The Witness: Yes, they carried the same cargoes but it took them longer to complete a voyage.

The Court: So if it took them twice as long to complete a voyage you would need twice as many ships to carry the same amount of cargo, and that caused a rise in freight rates, and a rise in what ships were selling for, bringing in the market?

The Witness: That's right.

The Court: And the peak of this economic effect was in January and February of 1957?

[fol. 68] The Witness: Yes.

The Court: Then it began to fall off. Will you explain that?

The Witness: Well, the reason it started to fall off, of course, was that, number one, the governments in Europe had stockpiled in anticipation of a long delay in the opening of the Suez Canal. It stockpiled various commodities. I can state, for example, in Holland the government wrote to every consumer of oil asking them how much oil they had on hand, how much they consumed per year, and based on these facts they went to the oil companies and said, stockpile so many tons of oil. Of course, what happened with the Dutch citizen there is that they were afraid of rationing, and therefore, when asked the question how much oil they had on hand, they only stated about 50 percent of what they had on hand, and consumption, on the other hand, they stated at 200 percent, so the forecasts were completely incorrect, and all of a sudden the European countries found themselves with tremendous stockpiles and unable to find a place to put the goods any more. So as soon as this became apparent, of course, the activity of carrying goods slowly ground to a halt, and consequently the need for bottoms, or tonnage to carry these goods, was no longer there, and the charter rates dropped off.

The Court: The demand decreased?

The Witness: That's correct.

The Court: Well, that is very interesting. Anything further.

Mr. Lewis: Nothing, your Honor.

[fol. 69] The Court: Thank you very much, sir. You are excused.

• • • • • • •

MICHAEL J. NASSAU was called as a witness on behalf of the petitioner and, being first duly sworn, testified as follows:

* * * * * * *

Direct examination.

By Mr. Lewis:

* * * * * * *

Mr. Lewis: I would like this document marked for identification.

(The document referred to was marked Petitioner's Exhibit 13 for identification.)

Q. I show you a schedule of charter rates covering the years 1957 and 1958 and ask you if you prepared that.
A. Yes, I did.

Q. Will you describe the sources from which it was taken?
A. Yes, this was prepared from the weekly bulletins prepared by Maritime Research, which was described earlier by Mr. Lillianthal.

Q. What information does this schedule contain?
A. The schedule shows each week in which there was a fixture, a charter fixture, for heavy grain by both American flag tanker and American flag liberty-sized vessel, and it shows the name of the vessel, the tonnage, commodity, terms, dates, and also the rate. The main purpose was to compare the rate at which a tanker would charge for a shipment and the rate which a liberty-size vessel would charge for that same shipment over the same trade route.

[fol. 70] Q. How did these rates compare?
A. In every case the tanker rate is lower, and on the chart you can see the differences because the tanker rate is starred and the liberty-size vessels are not—and they are next to each other.

Mr. Lewis: I offer this schedule in evidence.

* * * * * * *

ROBERT E. SORENSEN was called as a witness for the petitioner and, being first duly sworn, testified as follows:

* * * * * * *

Direct examination.

By Mr. Lewis:

Q. What is your profession?

A. I'm the head of the marine engineering department for Luria Brothers.

Q. How many years of experience have you had in this work?

A. Fifteen with Luria Brothers and 16 prior to that with others.

Q. What are your duties?

A. Presently, and mainly, the figuring of ships for dismantling, scrapping, and I also specialize in handling special cargoes.

Q. Does your company enter bids for ships for scrapping?

A. Constantly.

Q. Did it do so in 1957?

A. Yes, it did.

Q. Does your profession require you to be familiar with the scrap values of ships?

A. Yes.

Q. Have you an opinion as to the scrap value of an American flag liberty ship in December of 1957?

[fol. 71] Mr. Hance: Your Honor, I object to these questions. I don't see the materiality of the scrap value of this vessel in trying to determine its salvage value in 1957.

The Court: The objection is overruled.

Q. What is that opinion?

A. Around $90,000 to $142,000.

Q. On what do you base that opinion?

A. I base that on bids accepted by the United States Maritime Commission for the scrap liberty ships which they sold at that time.

Mr. Lewis: May I have this document marked for identification?

(The document referred to was marked Petitioner's Exhibit 14 for identification.)

Q. I show you this letter. Are you familiar with it?
A. Yes.

Q. Can you describe it?
A. It's a letter sent to me by Mr. Doty, chief of the ship sales and disposal branch of the United States Maritime Commission.

Q. Will you describe the information on there?
A. I asked Mr. Doty for information concerning the sale of ships at various times, and in this is included a bid which they received, and under which they sold ships identified as PDY-538.

Q. Is this a part of the public records of the Maritime Commission?
A. Yes, it is.
Q. Can you describe the bids, please?

The Court: What is PDY-538?
The Witness: Merely an identification number for their bids which they bring out periodically.

[fol. 72] Q. What is the date of this information? As of what date was it compiled?
A. The high bidders were accepted on—
Q. No, as to what period of time does this relate?
A. December 13, 1957.

Q. Can you describe the accepted bids?
A. There were nine ships sold on that date and they ranged in price from 83,000 to a high of $141,241.41.
Q. Could you read the entire list of accepted bids?
A. The Oscar Shappel, the sales price was $88,636, and was sold to the J. C. Burkwick Company, 551 Fifth Avenue, New York. Shall I read the entire list?
Q. Would you read the list of prices, please?
A. $88,668; $83,663; $88,636; $141,241.41; $90,388.88; $83,000; $86,416.69; $85,889.99.

Q. What would you have bid for a liberty ship for junking at that time?
A. I think my bid would have been lower than this by possibly $30,000.

Q. How do you determine the price that you will bid?

A. We can get a quick evaluation of the value of a ship by using the metallic weight involved, which, in the case of a liberty, is roughly 3,000 tons of steel and, at a maximum, 30 tons of non-ferrous materials. The value is tied in closely with the value of No. 1 steel, which would be that price multiplied by 3,000 gross tons. Then, from that we would subtract our preparation cost, towing, insurance, etc.

The Court: In other words, you make a bid in an amount that will about equal what you can sell the scrap iron for?

The Witness: Yes. However, at the time of bidding you are naturally influenced by the future of the market, because, actually, in buying a ship you are buying futures be- [fol. 73] cause it takes time to prepare that scrap and get it to the market, so it's largely a gamble if you figure closely. There are many things that could influence it besides the No. 1 scrap. Namely, there is a possibility of cutting what we call reroll material from it, which would be valued at perhaps $15 a ton more than the price of No. 1 scrap. Also, early in the program the salvage equipment had value. As the program unfolded and liberty ships were scrapping, were very plentiful, there was less demand for, or less ability to sell, the usable equipment.

Therefore, late in the program you would evaluate the equipment pure as scrap.

By Mr. Lewis:

Q. In December of 1957 were scrap prices rising or falling?

A. I would say they were falling.

Q. You have read to the Court the prices at which these nine liberty ships were sold for scrapping. One at a price of $141,000 and the others all at prices below $91,000. What is your opinion as to the appropriate prices at that time?

A. Well, I would say that the higher price was the result of an uninformed bid. By that I mean I think the people made a mistake. I think they bid too high.

Mr. Lewis: That is all I have. I would like to offer this exhibit in evidence, please.

Mr. Hance: I have no objection to it, your Honor.

The Court: Exhibit 14 is received in evidence.

* * * * * * *

OVERSIZE PAGE-S

Voyage Charter Fixtures Reported to and Publis
Research, Inc. for Shipment of Heavy Grain in
Vessels of Liberty-type Size for Weeks Ending
October 1955 to December 1958, Inclusive, for
for Which Such Reports Were Made for Ten or Mo

Trade Route	1955 Oct.-Dec.	1956 Jan.-Mar.	1956 Apr.-Ju
U.S. Gulf - Haifa	19.00	-	H 22.2 L 21.5
Northern Range - Yugoslavia	H 15.35 L 15.15	H 16.65 L 15.40	18.7
U.S. Gulf - Piraeus	H 18.00 L 16.50	H 17.15 L 16.75	21.9
No. Pacific - Korea	H 17.00 L 16.35	H 18.00 L 17.25	H 18.5 L 18.0
No Pacific - Japan	-	-	-
Northern Range - Poland	-	-	-
U.S. Gulf - Poland	-	-	-
U.S. Gulf - Karachi	H 24.95 L 23.40	-	28.4
No. Pacific - Formosa	15.85	17.50	18.5

* Rates are in dollars per long ton, terms free discharge. Exclud
and charters for consecutive voyages, part cargoes, or multiple p
high, L means low and B means barley.

CE NEXT FRAME

EXHIBIT 6

Fixtures Reported to and Published by Maritime
for Shipment of Heavy Grain in American Flag
rty-type Size for Weeks Ending in the Months
o December 1958, Inclusive, for Trade Routes
Reports Were Made for Ten or More Such Weeks.*

5 Dec.	1956 Jan.-Mar.	1956 Apr.-June	1956 July-Sept.	1956 Oct.-Dec.	1957 Jan.-Mar.	1957 Apr.-June	1957 July-Sept.	1957 Oct.-Dec.	1958 Jan.-Mar.	1958 Apr.-June	1958 July-Sept.	1958 Oct.-Dec.
.00	-	H 22.25 L 21.50	H 21.50 L 18.25	19.40	-	19.25	14.00	H 15.00 L 14.25	H 16.00 L 15.10	H 15.50 L 14.50	H 15.00 L 14.25	14.00
.35 .15	H 16.65 L 15.40	18.75	-	-	-	19.07	-	-	H 15.75 L 14.75	H 15.75 L 12.50	H 12.75 L 12.50	-
.00 .50	H 17.15 L 16.75	21.90	H 18.50 L 18.00	H 19.50 L 19.25	H 20.85 L 19.00	18.66	-	-	14.50	15.00	-	-
.00 .35	H 18.00 L 17.25	H 18.50 L 18.00	-	18.50	H 18.50 L 18.43	H 14.75B L 14.00B	H 13.20 L 11.50	H 11.50B L 11.25	H 13.00 L 11.00	-	14.00	-
-	-	-	17.00	-	-	H 13.75 L 13.35	10.85	H 10.75 L 10.35	-	10.50	12.00	8.75
-	-	-	-	-	-	13.85	12.00	H 13.25 L 12.80	-	H 13.00 L 12.30	H 14.75 L 12.10	-
-	-	-	-	-	-	-	H 13.50 L 13.40	H 14.35 L 13.50	-	H 14.35 L 12.75	H 14.75 L 14.00	-
.95 .40	-	28.44	-	H 34.00 L 33.50	-	-	-	21.10	H 24.75 L 23.50	-	-	-
.85	17.50	18.50B	18.50	18.50	H 20.25 L 18.50	-	13.00	13.00	13.00	13.00	-	14.00

, terms free discharge. Excludes rice shipments,
ges, part cargoes, or multiple parcels. H means
ley.

[fol. 75]

EXHIBIT 7

[Letterhead of]

U. S. TREASURY DEPARTMENT

WASHINGTON 25

October 6, 1953

T:S:EP
JHF

Messrs Zock & Petrie
52 Broadway
New York 4, New York

Attention: Mr. Anthony N. Zock
In re: ARROW BARGE COMPANY, INC.
No. 2 Broadway
New York, New York
Reference No. 539

Gentlemen:

This letter is in reply to your letters dated September 15, 1953 and September 30, 1953, with respect to your request for a ruling on behalf of your client, the Arrow Barge Company, Inc., that the useful life of the C1B type steam turbine, dry cargo vessel, the FLYING FOAM, shall be based upon a seven year period from the anticipated purchase date of October 15, 1953, and that the salvage value at the end of that time shall be estimated on the basis of $5.00 per dead weight ton.

After consideration of the information furnished in your letters and office conferences on September 16 and 21, 1953, and the affidavit of Mr. Harry A. Sperling, you are advised that the Internal Revenue Service cannot accept a seven [fol. 76] year life from date of purchase, but will accept a useful life of 20 years from date of construction, terminating October 10, 1964, for the C1B type steam turbine, dry cargo vessel, the FLYING FOAM, the cost at date of acquisition, expected to be October 10, 1953, less salvage value

computed at $5.00 per dead weight ton, shall be spread ratably over the period ending October 10, 1964.

It is understood that the termination date of October 10, 1964, is subject to such change as subsequent experience may warrant.

A copy of this letter is enclosed for the Arrow Barge Company, Inc.

Very truly yours,

R. C. STAEBNER
Chief, Engineering and Valuation Branch
Special Technical Services Division

Enclosure:
Copy of this letter

[fol. 77]

EXHIBIT 8

FRIBOURG NAVIGATION CORPORATION

SCHEDULE OF DAILY OPERATING COSTS—
S/S JOSEPH FEUER

PERIOD JUNE 21, 1957—OCTOBER 8, 1957

Wages (Including OT, Vacation, P&W)	$ 868
Subsistence	59
Deck, Engine & Stewards Sundries	63
Maintenance	7
Repairs	218
Insurance (Including Deductibles)	113
Miscellaneous	19
	$ 1,347

[OCT/DEC 1957]

VOYAGES ESTIMATES

S/S US FLAG LIB — DW. 10920 — Rate $1347 — Start GALV
Cargo Bulk Wheat — From GALV — To HAIFA
Speed 10 Knots on 25 f.o. — Cbc. Ft. Bale — Total
" " Grain — Total
" " Grain — Lower Holds

Draft Loaded
Depth Ldg. Port — Depth Disch. Port
Ballast tons, including Deep Tank tons.

Total DW. Summer Freeboard.. 10920 tons
Less: Allowance for Winter Marks.... tons
" burn-out to 36°N...... tons
Stores.................................... 150
Shifting Boards/Dunnage.................. 75
Water..................................... 100
500 Bunkers from GALV to CEUTA
or 4730 miles equal 20 days steaming
plus margin and dead oil................ 650
975
9945 tons

Add for Tropical Draft..

Leaving available for cargo .... 9945 tons

@ ft. = ft. Grain = Qrs.
Lower holds & Feeders take tons H.G. To Bag tons / bags.

4730
+028
4758

	Miles	Days	Fuel
Shifting from			
ldg. + fit tons...		7	35
Voyage............	4758	29	725
Disch. 3000 tons...		4	20
Shifting to GALV	4758	29	725
Sundry		7	
TOTAL		76	1505

Speed/consumption as per charter
Sundry covers 10% all time for S.&.H. and for bad weather; also 10% on coal when not B.W.bunkers.

REVENUE

9945 tons @ $15.00	149175
Less Comm. 2½ %	3729
NET REVENUE $	145446

Exch. @

DISBURSEMENTS

76 days Hire at $ 1347 per day.........................$	102372	
1505 tons Bunkers at $	32735	
Starting Port Outward $ — Redel. Port Inw. $ ..		
Loading Port Charges — NRT ......$ 2500		
Stevedoring — tons 3500	6000	
Grain Fittings/~~Dunnage~~ $ — ~~Bags~~ $ PART	2500	
Disch. Port Charges — NRT ......$ 2000		
Stevedoring — tons ...... FREE	2000	
Canal Dues NRT @ — Per Canal Net Reg........		
Ballast $ — , Day Despatch LOADING	750	
Gratuities & Overtime onboard $. monthly; P. & I. $.		
Sundries $. per voyage..................................	2500	142857
(Per Day $) ~~PROFIT~~/LOSS $		3411

Printed in U.S.A.

OCT/DEC 1957

VOYAGES ESTIMATES

S/S US. FLAG. LIBERTY DW. 10920 Rate $1347 Start GALV

Cargo BULK WHEAT From GALV To POLAND (GDYNIA)

Speed 10 Knots on 25 f.o. Cbo. Ft. Bale Total

" " Grain Total

Draft Loaded " " Grain Lower Holds

Depth Ldg. Port Depth Disch. Port

Ballast tons, including Deep Tank tons.

Total DW. Summer Freeboard.. 10920 tons

Less: Allowance for Winter Marks.... 340 tons

" burn-out to 36°N...... 240 — 100 tons

Stores.................................... 150

Shifting Boards/Dunnage.................. 75

Water..................................... 100

55°
135

Bunkers from GALV to KIEL

or 5395 miles equal 22 days steaming plus margin and dead oil................. 700 — 1125

9795 tons

Add for Tropical Draft..

Leaving available for cargo .... 9795 tons

@ ft. = ft. Grain = Qrs.

Lower holds & Feeders take tons H.G. To Bag tons / bags.

5395
339

	Miles	Days	Fuel
Shifting from			
ldg. + FR tons...		7	35
Voyage..............	5734	24	600
Disch. 1300 tons...		8	40
Shifting to GALV..........	5734	24	600
Sundry		6	
TOTAL		49	1275

Speed/consumption as per charter
Sundry covers 10% all time for S.&.H. and for bad weather; also 10% on coal when not B.W.bunkers.

REVENUE

9795 tons @ 14.35	140.558
Less Comm. 2½ %	3514
NET REVENUE $	137.044

Exch. @

DISBURSEMENTS

49 days Hire at $1347 - per day..........................$	92943	
tons Bunkers at $	28343	
Starting Port Outward $ Redel. Port Inw. $ ..		
Loading Port Charges NRT ......$ 2500		
Stevedoring tons 3500	6000	
Grain Fittings/Dunnage $ Bags $ PART	2500	
Disch. Port Charges NRT ......$ 2500		
Stevedoring tons ...... FREE	2500	
Canal Dues NRT @ Per Canal Net Reg........		
Ballast $ 1 Day Despatch Ldg. 4750	750	
Gratuities & Overtime onboard $. monthly; P. & I. $.		
Sundries $. per voyage..................................	2500	135.536

Printed in U.S.A. (Per Day $) PROFIT/~~LOSS~~ $ 1508

OCT/DEC 1957

VOYAGES ESTIMATES

S/S US. FLAG LIBERTY DW. 10920 Rate $1347.- Start GALV
Cargo BULK WHT From GALV To KARACHI
Speed 10 Knots on 25 f.o. Cbo. Ft. Bale Total
" " Grain Total
Draft Loaded " " Grain Lower Holds
Depth Ldg. Port Depth Disch. Port
Ballast tons, including Deep Tank tons.

Total DW. Summer Freeboard........ 10920 tons
Less: Allowance for Winter Marks.... tons
" burn-out to 36°N...... tons
Stores........ 150
Shifting Boards/Dunnage........ 75
Water........ 100
Bunkers from GALV to CULTA
or miles equal days steaming
plus margin and dead oil........ 650
975
9945 tons
Add for Tropical Draft........
Leaving available for cargo .... 9945 tons
@ ft. = ft. Grain = Qrs.
Lower holds & Feeders take tons H.G. To Bag tons / bags.

	Miles	Days	Fuel
Shifting from			
ldg. + FIT tons...		7	35
Voyage........	9539	40	1000
Disch. 1000 tons...		10	50
Shifting to GALV	9539	40	1000
Sundry		10	
TOTAL		107	2085

Speed/consumption as per charter
Sundry covers 10% all time for S.&.H. and for bad weather; also 10% on coal when not B.W. bunkers.

REVENUE

9945 TONS @ 21.10	209839
Less Comm. 2½ %	5245
NET REVENUE $	204594

Exch. @

DISBURSEMENTS

107 days Hire at $ 1347.- per day........$	144129	
2085 tons Bunkers at $	43851	
Starting Port Outward $ — Redel. Port Inw. $ ..		
Loading Port Charges — NRT ......$ 2500		
Stevedoring — tons @35¢ 3500	6000	
Grain Fittings/~~Dunnage~~ $ — ~~Bags $~~ PART	2500	
Disch. Port Charges — NRT ......$ 1.000	1000	
Stevedoring — tons ...... FREE		
Canal Dues NRT @ Per Canal Net Reg........	1.500	
Ballast $ — DESPATCH (LOADING - DAY @ 750	3000	
	750	
Gratuities & Overtime onboard $. monthly; ~~P. & I. $~~ .		
Sundries $. per voyage........	2500	210230

Printed in U.S.A. (Per Day $) ~~PROFIT~~/LOSS $ 5636

1

Permenent bunkers
Tanks

B U N K E R E S T I M A T E

S/s US FLAG. LIBERTY voy.

Oil Gravity   Visc.   Flash   F. Pour   Forced Draft ?

10 knots on 25
240 miles per day

Port	due	arrived		sailed		fin.	miles	days		Bunkers					
		date	hour	date	hour			sea	prt	plus	uses	arrvl	supply	slg	
GALV	Nov/Dec													650	2.65 .7 2.72 17.95
CEUTA							4730	20			500	150	300	450	17/6/- 24.64
PORT SAID							1942	8			200	250			
ADEN							1396	6			150	100			27.24 .40 21.84
Karachi							1471	6	10		150				
GALV							9539	40			1000				
												650 300 135 2085	17.95 24.65 21.84	11668 7395 24788 43851	

[fol. 82]

EXHIBIT 12

JACQ. PIEROT JR. & SONS

"AMERICAN EAGLE"	33000	1959
"ATLAS"	35400	1958
"BARBARA JANE"	31500	1959
"EAGLE VOYAGER"	31800	1959
"PENN CHALLENGER"	33173	1960
"OCEAN ULLA"	35500	1960
"ERNA ELIZABETH"	33000	1959
"MOUNT VERNON VICTORY"	46200	1961
"ACHILLES"	41200	1960
"EAGLE TRANSPORTER"	26500	1958
"EAGLE COURIER"	26500	1958
"HANS ISBRANDTSEN"	32700	1958
"TRANSEASTERN"	46400	1959
"NATIONAL DEFENDER"	66500	1959
"ORION HUNTER"	67000	1961
"SISTER KATINGO"	33000	1958
"ATLANTIS"	33000	1958
"SAROULA"	31500	1958
"TITAN"	47400	1960
Total	731273	

[fol. 83]

EXHIBIT 13

COMPARISON OF RATES CHARGED BY AMERICAN FLAG TANKERS WITH RATES CHARGED BY AMERICAN FLAG LIBERTY-TYPE SIZE VESSELS FOR VOYAGE CHARTERS FOR SHIPMENT OF HEAVY GRAIN

Consisting of all instances where voyage charter fixtures for heavy grain were reported to and published by Maritime Research, Inc. for both tankers and liberty-type size vessels for the same week and the same trade route during period October 1955 through December 1958.

Trade Route	Vessel	Tons	Commodity	Terms	Dates	Rate*
Week ending 9/14/57						
USGulf to Poland	ATLANTIC STATES	12000–5%	Hvy Grain	—	Sep. 20/30	12.50*
" "	NATIONAL MARINER	9500–5%	" "	FD	Sep.	13.40
" "	SEASTAR	"	" "	"	Sep. 25/15 Oct.	13.50
Week ending 11/2/57						
USGulf to Trieste	ATLANTIC STATES	13500–5%	Hvy Grain	Gross Terms	Nov. 15/30	13.50*
" "	WESTPORT	9500–5%	" "	FD	Nov. 15/30	15.35
" "	EVIBELLE	"	" "	"	Feb.	19.00
Week ending 2/8/58						
USGulf to Karachi	PAN OCEANIC TRANSPORTER	14000–10%	Wheat	Gross Terms	Early Mar.	17.85*
" "	GREEN VALLEY	9500–5%	"	FD	Mar.	24.25
Week ending 3/15/58						
USGulf to Turkey	BULKCRUDE	20000	Wheat	Gross Terms	Mar.	13.75*
" "	BOSTON	9500–10%	"	FD	Mar. 23/7 Apr.	17.50

*Asterisks represent tankers; unmarked figures represent liberty-type size vessels.

[fol. 84]

Exhibit 13

Trade Route	Vessel	Tons	Commodity	Terms	Dates	Rate*
Week ending 4/5/58						
NoRg to TurkeyMed	BULKCRUDE	16000–10%	Hvy Grain	Gross Terms	Apr./May	11.95*
" "	STEAMER	9500–5%	" "	FD	Apr. 25/25 May	15.50
						[247]
Week ending 8/9/58						
USGulf to Bombay	TANKER	15000	Wheat	Gross Terms	Aug. 20/5 Sep.	20.00*
" "	JOSEFINA	9500–5%	"	FD	Aug.	23.75
" "	PACIFIC CARRIER	"	"	"	Sep. 5/30	24.00
Week ending 8/16/58						
USGulf to Bombay	TANKER	15000	Wheat	Gross Terms	Sep.	18.00*
" "	TANKER	"	"	" "	Sep.	18.00*
" "	CAPTAIN NICHOLAS	"	"	" "	Sep. 1/30	18.00*
" "	OCEAN JOYCE	9500–5%	Hvy Grain	FD	Aug. 25/7 Sep.	23.75
Week ending 10/11/58						
NoPac to Bombay	WANG GOVERNOR	15000	Wheat	Gross Terms	Oct.	17.00*
" "	PRODUCER	"	"	" "	"	17.00*
" "	BARBARA	"	"	" "	"	17.00*
" "	STEAMER	9500–5%	"	FD	"	24.50
Week ending 12/6/58						
USGulf to Greece	NATIONAL PEACE	15000–10%	Hvy Grain	FD	Dec. 26/10 Jan.	13.25*
" "	PENN MARINER	9500–5%	Corn	FD	Dec./Jan.	14.42
Week ending 12/20/58						
USGulf to Bombay	BARBARA	15000–10%	Wheat	Gross Terms	Jan.	17.00*
" "	PACIFIC WAVE	9500–5%	Corn	FD	Jan. 10/24	23.50

*Asterisks represent tankers; unmarked figures represent liberty-type size vessels.

[fol. 85]

EXHIBIT 14

[Letterhead of]

U. S. DEPARTMENT OF COMMERCE
MARITIME ADMINISTRATION
WASHINGTON 25, D. C.

IN REPLY REFER TO:
SD:528(P)

June 1, 1962

Luria Brothers & Company, Inc.
Chrysler Bldg.
New York 17, N. Y.
Attention: Mr. R. E. Sorensen

Gentlemen:

Pursuant to your telephone inquiry of May 31, 1962, we enclose copies of abstracts of bids received for Liberty ships offered for scrap during the period January 1, 1954 and December 31, 1957, under Invitations for Bids No. PD-X-517, 525 and 538.

Award of the five ships under PD-X-517 was made to Boston Metals Company for the sum of $353,885 and award of the E. KIRBY SMITH was also made to that Company at their bid price of $147,777.77. Enclosed is a copy of the action taken with respect to the bids under PD-X-538.

Sincerely yours,

M. C. DOTY
M. C. Doty, Chief
Ship Sales and Disposal Branch
Division of Purchase and Sales

Enclosures

[fol. 86]

ACTION TAKEN ON DECEMBER 13, 1957 WITH RESPECT TO BIDS RECEIVED UNDER INVITATION FOR BIDS NO. PD-X-538

Vessel	Sales Price	Successful Bidder
Oscar Chappell	$ 88,636.00	J. C. Berkwit & Company
George R. Poole	88,668.00	551—5th Avenue
Fort Lawrence	83,636.00	New York 17, New York
R. J. Reynolds	88,636.00	
Fort Liard	$141,241.41	Sampson Iron & Supply Co. 999 Crockett St. Beaumont, Texas
Benjamin Franklin	$ 90,388.88	General Metals of Tacoma, Inc. 1919 Canal Street Tacoma, Washington
Henry Wynkoop	$ 83,000.00	Gibbs Corporation Ft. of Hendricks Avenue Jacksonville, Florida
Richard J. Oglesby	$ 86,416.69	The Learner Company 3675 Alameda Avenue Oakland, California
Arthur A. Penn	$ 85,889.99	Dulien Steel Products Inc. of Washington 9265 East Marginal Way Seattle, Washington
Fort Chambly	—	All bids rejected
Fort Pitt	—	" " "

Note: All awards made under Condition 2 requiring complete scrapping of the hulls of the vessels.

[fol. 87]

IN THE UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

No. 72—September Term, 1963.
Argued January 16, 1964
Docket No. 28165

FRIBOURG NAVIGATION COMPANY, INC., Petitioner,

—v.—

COMMISSIONER OF INTERNAL REVENUE, Respondent.

Before: Swan, Moore and Smith, Circuit Judges.

Petition to review a decision of the Tax Court of the United States, Marion J. Harron, *J.*, upholding disallowance of a depreciation deduction for taxable year in which an asset was sold for more than its depreciated cost. 39 T. C. Memo. 1962-290. Affirmed.

James B. Lewis, New York, N. Y. (Theodore Ness, Michael J. Nassau and Paul, Weiss, Rifkind, Wharton & Garrison, New York, N. Y., on the brief), for petitioner.

[fol. 88] William A. Friedlander, Attorney, Dept. of Justice, Washington, D. C. (Louis F. Oberdorfer, Asst. Atty. General, Lee A. Jackson and Harry Baum, Dept. of Justice, Washington, D. C., on the brief), for respondent.

OPINION—July 15, 1964

Smith, *Circuit Judge*:

The sole issue presented by this appeal is whether a taxpayer is entitled to a depreciation deduction for the year in which a depreciable asset is sold at more than its depreciated cost. The Tax Court sustained the Commissioner's disallowance of the deduction, and the taxpayer has appealed to this court. We agree with the Tax Court's determination and affirm the judgment.

The taxpayer, Fribourg Navigation Co., operated two cargo ships in foreign commerce. One of these was the *S.S. Feuer,* a Liberty ship purchased in December of 1955 for $469,000. Just prior to purchasing the *Feuer,* the taxpayer secured a letter ruling from the Engineering and Valuation Branch of the Internal Revenue Service advising that it would accept straight line depreciation of the ship over a useful economic life of three years, subject to change if warranted by subsequent experience. The letter ruling also advised that the Internal Revenue Service would accept a salvage value of $54,000 on the *Feuer.* This estimate of the *Feuer's* useful economic life and salvage value, concededly reasonable in December of 1955, was thrown out of kilter by a scarcity of ships resulting from the Suez Crisis of 1956-57, which sharply inflated the values of ships normally considered obsolete. In June of 1957 the taxpayer accepted an offer to sell the *Feuer* for $700,000, $231,000 more than it had paid for the ship a year and a half before. When the *Feuer* was delivered to its new owner on Decem-
[fol. 89] ber 23, 1957, the contract terms were slightly modified, reducing the purchase price to $695,500.

Relying on the letter ruling, the taxpayer deducted the $54,000 estimated salvage value from the $469,000 cost and spread the $415,000 equally over a three year useful life—from December 21, 1955 to December 21, 1958. This resulted in a daily depreciation of about $378.65. On its income tax returns, the taxpayer claimed the following depreciation deductions for the *Feuer*:

Calendar Year	Period of Ownership	Depreciation
1955	10 days	$ 3,786.50
1956	366 days	138,585.77
1957	357½ days	135,367.24
	Total	$277,739.51

On March 7, 1957, prior to the sale of the *Feuer,* the taxpayer adopted a plan of complete liquidation, which was carried out within 12 months. Since the liquidation came within the sanctuary of Section 337 of the Internal Revenue Code, the taxpayer incurred no tax liability on the capital gain from the sale of the *Feuer.* For information purposes only, the taxpayer reported a capital gain of $504,239.51 (the difference between the selling price and the adjusted basis after taking a depreciation allowance for 357½ days of 1957). The taxpayer reported a gross income (after cost of operations) of $391,811.31 in 1957. This was reduced to $141,193.35 after deductions of $250,617.96, including $135,367.24 for the depreciation of the *Feuer* in 1957.

The Commissioner disallowed the $135,367.24 deduction in full, taking the position that a taxpayer cannot depreciate an asset during the year its sale reveals that it has not depreciated. At the start of 1957 the *Feuer* had an [fol. 90] adjusted basis of $326,627.73. In December of 1957 it was sold for $695,500. The Commissioner claims Congress never intended to permit further depreciation under such circumstances, and that a depreciation deduction claimed when the taxpayer knows with certainty that the asset has appreciated rather than depreciated must be disallowed as unreasonable. The Commissioner does not seek to recapture the depreciation deductions allowed for 1955 and 1956. He is content with contending only that depreciation disallowance should be limited to the year in which an asset is sold for more than its adjusted basis.

Though perhaps logically inconsistent, this position is strongly suggested by the opinion of the Sixth Circuit in *Cohn* v. *United States,* 259 F. 2d 371 (1958), which first permitted the Commissioner to disallow depreciation deductions on assets sold for more than their adjusted basis. In 1941-42 the taxpayers in *Cohn* began to operate three flying schools to train pilots under the Army Air Corps Contract Flying School Program. The taxpayers determined that their contracts for operation of the schools would terminate at the end of 1944, and the equipment they had purchased to operate the schools should be depreciated

over a useful economic life ending on December 31, 1944. In computing their depreciation deductions, the taxpayers neglected to place any salvage value on the equipment, though operators of similar flying schools used an estimated salvage value of ten percent in establishing their depreciation schedules. One of the schools ceased its operations on August 4, 1944, and its equipment was sold at auction during that month. The property of the other two schools was auctioned off in November of 1944. Because of wartime shortages, the equipment brought substantial sums, exceeding the adjusted basis of the assets at the beginning of 1944. The Commissioner disallowed the depreciation deductions for all the years as excessive and unreasonable. [fol. 91] The District Court found that a salvage value of 10% of the original cost should have been used in computing the depreciation schedules and that the actual sales price should have been substituted for the salvage value in the year in which the asset was sold. Only the latter holding was appealed to the Sixth Circuit, which affirmed the District Court.

The holding of *Cohn* has been variously construed. Some have taken a very narrow view, reading *Cohn* as holding only that on the peculiar facts the District Court's finding that the salvage value should be redetermined in the year of the assets' sale to reflect the sales price was not clearly erroneous. Others have considered it to lay down a rule of law that the depreciation deduction for the year in which an asset is sold must be adjusted to limit the deduction to the amount, if any, by which the adjusted basis at the start of the year exceeds the sales price. Compare *Motorlease Corp.* v. *Comm.*, 215 F. Supp. 356, 361-64 (D. C. Conn. 1963) (rev'd on appeal, July , 1964) and Note, 41 Ore. L. Rev. 159, 165-66 (1962) with *Randolph D. Rouse*, 39 T. C. 70 (1962); Rev. Rul. 62-92, 1962-1 C. B. 29; and Note, 37 Tex. L. Rev. 787 (1959).

Though it could have been more explicit, we think that the *Cohn* case adequately supports the Commissioner's position and supports affirmance of the Tax Court's decision in this case. Section 167(a) of the Internal Revenue Code states as a general rule: "There shall be allowed as a depreciation deduction a reasonable allowance for the ex-

haustion, wear and tear (including a reasonable allowance for obsolescence) . . . of property used in the trade or business . . ." Thus the dispute centers about whether it is reasonable to allow a deduction for depreciation in the year in which an asset is sold for more than its adjusted basis. We think such an allowance unreasonable, for it contravenes the basic purpose of the depreciation deduction. [fol. 92] Basically, our income tax is a tax on net income, and the expenses of generating income are normally considered deductible from gross income. The purpose of the depreciation allowance is to enable the taxpayer to recover the net cost of a wasting asset used in his trade or business by charging the diminution in the asset's value each year against the gross income of that year. Because our income tax system is based on annual reporting and liability and the taxpayer normally holds wasting assets for more than a year, the proper amount of depreciation to be taken each year must depend on estimates. The proper depreciation allowance "is that amount which should be set aside for the taxable year in accordance with a reasonably consistent plan (not necessarily at a uniform rate), so that the aggregate of the amounts set aside, plus the salvage value, will, at the end of the estimated useful life of the property, equal the cost . . . of the property . . ." Treasury Regulations, §1.167(a)-1. See also *United States* v. *Ludey*, 274 U. S. 295, 300-301 (1927).

The Commissioner does not claim that the depreciation schedule adopted by the taxpayer in 1955 when the *Feuer* was purchased was unreasonable. Rather his claim is that it is unreasonable to follow an estimate when one knows that estimate is incorrect. The Commissioner's position finds support in §1.167(b)-0 (a) of the Regulations in force during 1957:

> "Any reasonable and consistently applied method of computing depreciation may be used or continued in use under section 167. Regardless of the method used in computing depreciation, deductions for depreciation shall not exceed such amounts as may be necessary to recover the unrecovered cost or other basis less salvage during the remaining useful life of the property. The

> reasonableness of any claim for depreciation shall be [fol. 93] determined upon the basis of conditions known to exist at the end of the period for which the return is made."

We think the Regulations make it plain that the relevant time for assessing the reasonableness of the depreciation deduction is the end of the period for which the return is made. At the end of 1957 it hardly seems reasonable to claim that the value of the *Feuer* had declined below its adjusted basis.

To be sure, the Regulations also provide that the depreciation allowance "shall not reflect amounts representing a mere reduction in market value." §1.167(a)-1. If depreciation schedules had to be revised each time an asset's market value rose or declined, an intolerable strain would be placed on accounting methods. But no such practical difficulty presents itself here. All that is required is a comparison of the asset's selling price with its adjusted basis. A sale which indicates that an estimated decline in an asset's value is greatly out of line is not a "mere fluctuation in market value," but "a single and final adjustment in the closing of the books on the asset involved." *Cohn* v. *United States, supra,* 259 F. 2d at 378.

Though the increment in the *Feuer's* value resulted from a fortuity normally associated with capital gain, the depreciation allowance is measured by the net cost of the asset to the taxpayer. If an asset costs a taxpayer nothing for a year, the economic factors responsible for the lack of expense to the taxpayer should be of no concern in arriving at the depreciation allowance. Here the sale established with mathematical certainty that the entire cost of the ship had been recovered by the sale. No injustice results from denying the taxpayer an allowance he knows to be fictional at the time he claims it.

Little support for the taxpayer's position can be derived from Congressional passage in 1962 of §1245 of the Internal [fol. 94] Revenue Code. Section 1245 is addressed to a much broader problem than disallowance of depreciation deductions for the year of an asset's sale. The *Cohn* case

refused to permit the Commissioner to recapture depreciation in years other than that of an asset's sale. Section 1245 permits recapture of depreciation allowed in years prior to an asset's sale by treating gain on the transfer of certain specified property to the extent of depreciation taken after 1961 as ordinary income instead of capital gains. See generally, Schapiro, *Recapture of Depreciation and Section 1245 of the Internal Revenue Code,* 72 Yale L. J. 1483 (1963).

The judgment of the Tax Court is affirmed.

MOORE, *Circuit Judge* (dissenting):

By its decision in this case and in *United States* v. *The Motorlease Corporation,* decided this day, this court not only enacts judicial legislation which the Congress itself has rejected but overturns judicial and administrative precedents of many years' standing in the field of allowable depreciation.

The law in effect in 1957, the applicable year here, provided as to "DEPRECIATION" that "There shall be allowed as a depreciation deduction a reasonable allowance for the exhaustion, wear and tear (including a reasonable allowance for obsolescence)—(1) of property used in a trade or business, or (2) of property held for the production of income." (Sec. 167, Int. Rev. Code of 1954.) The basis, "for the purpose of determining the gain on the sale or other disposition of such property," was to be the "adjusted basis provided in section 1011." Sec. 167(f).

The Regulations provide for the setting aside as a depreciation deduction an amount "in accordance with a reasonably consistent plan," "so that the aggregate of the [fol. 95] amounts set aside, plus the salvage value, at the end of the estimated useful life of the depreciable property, equal the cost or other basis of the property as provided in section 167(f) and §1.167(f)-1."

"Useful life," here determined by the Commissioner to have been three years, was subject to modification "by reason of conditions known to exist at the end of the taxable year" and could be "redetermined" but "only when the change in the useful life is significant." §1.167(b).

The other important factor, "salvage value," is defined with clarity as "the amount (determined at the time of acquisition) which is estimated will be realized upon sale or other disposition—" §1.167(c)-1. The Regulation contains the injunctions that "Salvage value shall not be changed at any time after the determination made at the time of acquisition merely because of changes in price levels," and that "Salvage value must be taken into account in determining the depreciation deduction . . . " The time period during which depreciation is allowable is from the time "when the asset is placed in service" until it "is retired from service." Proportionate parts of one year's depreciation are allowable for the first and last years during which the asset is in service. §1.167(g)-10.

These underlying and controlling legal principles are clear. Their application to the facts of this case are (or should be) equally clear.

The asset or property is the S.S. Feuer. Its acquisition date was December 21, 1955—the price $469,000.

The Commissioner accepted "Useful life" as three years and salvage value as $54,000. The "reasonably consistent plan" required the setting aside of $378.65 a day for depreciation. If this were done, the "aggregate of the amounts set aside" ($415,000) "plus the salvage value" ($54,000) would equal the cost ($469,000).

[fol. 96] During 1957 the S.S. Feuer earned some $289,340 as gross profit. To achieve this profit the Feuer had to be used and after each day of its use it had suffered wear and tear (depreciation) to the extent of $378.65. The $289,340 was not the net income on which the petitioner under the law was required to pay taxes. Its obligation rested upon net income and net income was obtained only after depreciation ($135,367.24) was deducted. Thus far there can be no variance in thought or legal result—even by the Commissioner, the Tax Court or the majority.

But just as our much vaunted system of law on a national basis can be so easily ignored and repudiated both by judicial and extra-judicial fiats, even more so is this true on an international basis. International law and contract to the contrary, the Suez Canal was closed to shipping in the latter part of 1956. Suddenly the price of ships soared, petitioner chose to forego the balance (approximately one

and a half years—or one-half of the agreed-upon useful life) of the contemplated three-year reasonable plan period and sold the Feuer in June 1957 for $700,000 (actually $695,500 on closing).

The tax computation should have been simple. The cost ($469,000) less depreciation to the date of sale ($277,739.51) enabled petitioner because of its sale for $695,500 to obtain a capital gain of $504,239.51, which petitioner reported.

Particularly important is it to note that although the Suez crisis had radically affected the shipping situation and ship values, the Commissioner did not avail himself of the remedy of modification of useful life and after such redetermination then, but only then, of a redetermination of salvage value. Actually his own regulation prevented him from changing salvage value "merely because of changes in price levels."

Faced with this insurmountable barrier of Congressional enactment, precedent, and regulation, the Commissioner [fol. 97] resolved the problem by the simple and much-used device of amending the statutes without the aid or even participation of Congress. To the depreciation allowance section he merely added in substance the words "except in the event that the asset shall be sold prior to the expiration of its useful life, in which event no depreciation shall be allowed for the year in which such sale is made if the price realized exceeds the depreciated cost at the beginning of such taxable year."

There would have been nothing wrong with such a statute; in fact, the Treasury had been trying to have similar provisions enacted for years. If, however, under our three branches of government system, the legislative branch does not function to the satisfaction of the executive and judicial branches, it is apparently incumbent on the latter two to take over the legislative powers. To be sure the taxpayer had planned his business transaction relying on the law as it was on the books at the time but sooner or later taxpayers must learn not to rely upon Commissioner's rulings, acquiescences, prior audits—or even Commissioners and courts.

What possible rationale is available for the result reached by the majority? They first infer that the Commissioner

is being quite magnanimous in being "content" with only a 1957 disallowance as if taxes and the law were to depend on Commissioners' whims, caprices and contentment. They recognize that in so doing that the Commissioner was "perhaps logically inconsistent" as indeed he was. In enacting his own *ex post facto* legislation, he might just as well have had a sale for more than cost eliminate all depreciation for three years or even from the date of acquisition.

To arrive at its result the majority relies exclusively on what it can only call a strong suggestion in *Cohn* v. *United States*, 259 F. 2d 371 (6th Cir. 1958). It ignores (as it must) the many Supreme Court decisions and the statutes [fol. 98] and regulations leading to a contrary result. When the *Cohn* case is read, no principle is found therein which could support the Commissioner's ruling. The taxpayers in *Cohn* had not fixed any salvage value for their property at the end of its useful life. For this value the District Court chose the sale price. There was no holding in *Cohn* that sale price during the course of useful life (here at the half-way point) should eliminate all depreciation in the year of sale. Nor can *Cohn* possibly be stretched to stand for the proposition that any "reasonably consistent plan" adopted by a taxpayer is to be considered as abrogated by a sale. Any such conclusion would be in specific disregard of the statutes and regulations which provide for the methods of redetermination of useful life and salvage value.

In *Randolph D. Rouse*, 39 T. C. 70 (1962) (the Tax Court here held it "necessary to recognize the *Rouse* case as dispositive of the question presented in this case") relied upon *Cohn*. Depreciation was disallowed only as to the houses which Rouse had sold. Since he had not adopted any "reasonably consistent plan" or estimated any salvage value at the time of acquisition a situation somewhat similar to that in *Cohn* existed. Neither set of facts leads to a result which should be controlling or even persuasive here.

The Tax Court assumed, erroneously and without any supporting basis in my opinion, that "changes in economic conditions have brought about new considerations by the courts of the old, well-established rules relating to de-

preciation allowances in the light of the rising market prices of used assets and the corresponding realization of large gains upon the resale of such used assets." *Massey Motors, Inc.* v. *United States,* 364 U. S. 92 (1960) and *Hertz Corp.* v. *United States,* 364 U. S. 122 (1960) are cited as examples for this proposition. Actually neither case justifies any [fol. 99] such conclusion. Both cases involved taxpayers whose business experience enabled them to determine an estimated salvage value based upon sales long before the end of the physical life of the automobiles used in their businesses. Instead of declaring the principle that sale automatically disqualified a taxpayer from claiming depreciation if the sale price was higher than the depreciated value at the beginning of the year, the *Massey* case, as to one of the taxpayers, used the estimated salvage value of $1,325 per car instead of the actual sales price of $1,380. Had the Supreme Court wished to declare the principle now urged by the Commissioner, it had every opportunity to do so merely by taking the actual sales price. However, it did not.

A thorough and well reasoned analysis of the depreciation problem is set forth in the trial court's decision in *The Motorlease Corporation* v. *United States of America,* 215 F. Supp. 356 (D. Conn. 1963). Although a panel of this court "On the authority of, and for the reasons given in *Fribourg Navigation Co.* v. *Commissioner,* 2d Cir. Docket No. 28165, decided today," reversed *Motorlease,* this case in reality supplies neither reasons nor authority. *Motorlease* reaches its result by saying "neither the Code nor the regulations are dispositive of the issue." To ignore the tax law as clearly written and the interpreting regulations is quite essential to a decision in contravention of such laws. This court in *Motorlease* does not believe that the transmutation of ordinary income into capital gains should be encouraged. Here is another example of the judicial enactment of a law which Congress itself over a long period of years had rejected. As pointed out in *Evans* v. *Commissioner,* 264 F. 2d 502, 513 (9th Cir. 1959), *rev'd on another ground sub nom. Massey Motors, Inc.* v. *United States,* 364 U. S. 92 (1960), "The legislative history

of section 117(j) shows that Congress had not receded from its original purpose. Congress was aware of the Com- [fol. 100] missioner's contention that taxpayers were converting into capital gains ordinary income arising from unreasonable deductions for depreciation." After reviewing various legislative attempts to have gain treated uniformly as ordinary income the court added tersely, "The recommendation was heard but not adopted." 264 F. 2d at 514.

In *Motorlease* the Commissioner did what he did not do in *Massey*. He took sale price as a new and substituted salvage value despite the specific requirement that it was to be "determined at the time of acquisition." Thus *Motorlease* as decided by this court in substance and actuality goes contrary to the decisions of the Supreme Court in *Massey* and *Evans*.

The factual distinction which makes *Fribourg*, even as the majority decide it, completely inapplicable to *Motorlease*, is that *Fribourg* admittedly does not deal with a business which consisted of short time use of property and its sale before the expiration of its physical life. *Motorlease* was analogous to, and should have been controlled by, *Massey, Evans* and *Hertz*. Yet there is no consideration of, or even mention of, those important cases or the legal principles declared therein.

Another series of illuminating beacons the light of which is more than adequate to reveal the right path are recent district court cases from other circuits.

In *Wyoming Builders, Inc.* v. *United States*, decided March 25, 1964, U. S. D. C. D. Wyo., the court was confronted with a refund case involving the disallowance of depreciation on property sold two months before the close of the taxpayer's fiscal year (November 1, 1957—October 31, 1958). The property, an Air Force base housing project, had been set up on a seventy-five year lease basis, all improvements to remain the property of the government upon expiration or termination. When the property was sold to the government in 1958, the taxpayer, as here, [fol. 101] reported as a capital gain the difference between the sale price and the cost less eight years' depreciation.

The court considered the applicable statutes and regulations as well as the *Cohn* case and concluded that the government's theory that no depreciation occurred in the year of sale was untenable, saying in part:

> "Depreciation occurs by use; the use of the property by the taxpayer until September 1, 1958, when the sale took place, resulted in a continued depreciation of the property until September 1, 1958. The expense of using the property was properly allocated by the taxpayer to the period of time which was benefited by that asset, that is, from the beginning of the fiscal year in issue until the date of the sale. Depreciation is the measure of the cost of that part of the assets which has been used up or gradually 'sold' through wear and tear." *United States* v. *Ludey,* 274 U. S. 295, 301 (1927).

The conclusions of the court in *Wyoming Builders* are so consonant with the law that it is impossible to conjure up countervailing arguments. The court held that "Neither the law nor the regulations permit this court to substitute the term 'sale price' for the regulation's term 'reasonable salvage value,'" and that "to sustain the disallowance of taxpayer's depreciation deduction would require an unwarranted judicial extension of the Code and Treasury Regulations." The court believed, as do I, that, if the law is to be changed, "Congress, not the Court, must enact adequate controls and set the standards."

The history of the *Wier Long Leaf Lumber Co.* case, 9 T. C. 990 (1947) and the Commissioner's acquiescence (1948-1962), his non-acquiescence (1962) and its affirmance and partial reversal on other issues, 173 F. 2d 549 (5th [fol. 102] Cir. 1949), is relevant here. The Tax Court held that the sale of depreciated automobiles did not preclude any depreciation allowance in the year of sale and that "mere appreciation in value due to extraneous causes [here the Suez situation] has no influence on the depreciation allowance, one way or the other."

Kimball Gas Products Co. v. *United States,* 63-2 U. S. T. C. ¶9507, W. D. Tex. 1962 was brought for a refund for

overpayment of taxes due to the Commissioner's disallowance of depreciation in the year of sale (1959) of properties acquired in 1955 which for depreciation purposes had useful lives of seven years. The Commissioner disallowed one-half of the depreciation claimed in the year of sale. The court held that the taxpayer was entitled to the full depreciation and a tax refund.

The taxpayer in *S & A Company* v. *United States*, 218 F. Supp. 677 (D. Minn., 1963), a company manufacturing and selling outboard motors, sold its land and depreciable assets on April 1, 1956 to a company which continued the business. It claimed deduction for depreciation from September 1, 1955 to April 1, 1956 in its 1955-1956 fiscal year. The issue framed there was identical with the issue here. The court reviewed in detail the history of the tax laws material to the subject, the Regulations, the *Massey*, *Hertz*, *Cohn* and *Wier Long Leaf Lumber* cases and came to the conclusion that the Commissioner improperly disallowed the deduction. In the course of its opinion the court pointed out the distinguishing features of the *Cohn* case (assuming it to be correct), namely, that although "a sale of an asset at the end of its useful life for an amount in excess of its undepreciated cost at the beginning of the year will justify a redetermination of salvage value," it is equally clear that the Tax Court held that sale of assets prior to the end of "useful life" at a price in excess of undepreciated [fol. 103] cost at the beginning of the year of sale does not justify a determination of salvage value because the excess of price over cost is mere appreciation in value.

Refutation cannot be found in saying that these are only district court decisions. They are decisions which apply the tax statutes as they were written and the Supreme Court cases for the principles expounded therein. They do not attempt to ascribe to Congress an intent not enacted into law. Rather the legislative history has disclosed that Congress had been aware of the problem and had intentionally chosen not to act.

The fallibility of the majority opinion is that it completely ignores that law. The majority say "Because our income tax system is based on annual reporting . . . the

proper amount of depreciation to be taken each year must depend on estimates." They should have taken notice of the statutory words requiring that salvage value be "determined at the time of acquisition"—of necessity, an estimate. They then interpret the Commissioner's claim to be that it is "unreasonable to follow an estimate when one knows that estimate is incorrect." To impute such a claim to the Commissioner is to imply that he is unable to read, understand and follow the specific provisions of the law under which he can always seek to rectify an incorrect estimate. Instead of pursuing such a remedy here, the Commissioner concedes the accuracy both of useful life and the salvage value "determined at the time of acquisition."

Finding no support in law for its position and forced to concede that "the increment in the *Feuer's* value resulted from a fortuity normally associated with capital gain," the majority satisfy themselves with the belief that "no injustice results from denying the taxpayer an allowance he knows to be fictional at the time he claims it." Any such legal philosophy has the effect of writing depreciation al- [fol. 104] lowances and depreciation as a matter of sound accounting out of the tax laws. Possibly they intend by their opinion to do so because under such circumstances they say "the economic factors responsible for the lack of expense to the taxpayer should be of no concern in arriving at the depreciation allowance." This approach can scarcely be reconciled with their comment that "If depreciation schedules had to be revised each time an asset's market value rose or declined, an intolerable strain would be placed on accounting methods." It was for this very reason that the Regulation, §1.167(c), provided that "Salvage value shall not be changed at any time after the determination made at the time of acquisition merely because of changes in price levels." Of course, sales price can easily be compared with the depreciated cost at the beginning of the year. But there is no law or regulation which declares that in such event no depreciation shall be allowed if the sales price is higher. Therefore, because this decision seems to be completely at variance with the statutes and the applicable decisions, I must dissent.

[fol. 105]

IN THE UNITED STATES COURT OF APPEALS

SECOND CIRCUIT

Present: Hon. Thomas W. Swan, Hon. Leonard P. Moore, Hon. J. Joseph Smith, Circuit Judges.

FRIBOURG NAVIGATION COMPANY, INC., Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE, Respondent.

Appeals from the Tax Court of the United States.

JUDGMENT—July 15, 1964

This cause came on to be heard on the transcript of record from The Tax Court of the United States, and was argued by counsel.

On Consideration Whereof, it is now hereby ordered, adjudged, and decreed that the order of said The Tax Court of the United States be and it hereby is affirmed.

[fol. 106] [File endorsement omitted]

[fol. 107a] [File endorsement omitted]

[fol. 107]

IN THE UNITED STATES COURT OF APPEALS

FOR THE SECOND CIRCUIT

No. 28165

[Title omitted]

PETITION FOR REHEARING AND FOR STAY OF MANDATE—
Filed July 28, 1964

To the Honorable Circuit Judges Swan, Moore and Smith of the United States Court of Appeals for the Second Circuit:

Petitioner, Fribourg Navigation Company, Inc., respectfully petitions:

(a) for rehearing of the decision of July 15, 1964 by a panel of this Court consisting of Circuit Judges Swan, Moore and Smith, and suggests that the case be reheard in banc; and

(b) in the event that such petition for rehearing is denied, or is granted and the judgment affirmed, for a stay of the mandate, pursuant to Rule 28(c) of the Rules of this Court, pending the filing of a petition for a writ of certiorari in the Supreme Court of the United States, which petitioner represents to this Court that it intends to file.

The Court's decision was that a taxpayer is not entitled to any depreciation deduction for the year in which it sells [fol. 108] a depreciable asset for more than its depreciated cost at the beginning of the year. Petitioner contends that rehearing should be granted, and suggests that rehearing should be in banc, on the following grounds:

1. This Court's decision violates the basic principle of depreciation, which, like depletion, is a system for allocat-

ing the cost of an exhaustible asset against its production of income over its useful life. The "theory underlying this allowance for depreciation is that by using up the plant a gradual sale is made of it"; the "depreciation charged is the measure of the cost of the part which has been sold." *United States* v. *Ludey,* 274 U. S. 295, 301 (1927).

This Court's distortion of the principle so well stated by Mr. Justice Brandeis is easily illustrated: (a) X purchased in January for $200,000 a mine containing 200,000 tons of ore in place; mined 100,000 tons of the ore by December and sold it for $200,000; and, owing to a shortage in the type of ore, was able to sell the mine in December for $200,000. (b) Y produced a motion picture in January for $200,000; received $200,000 from its exhibition during the year; and, the picture having become popular, sold it for $200,000 in December. (c) Z chartered a ship in January for two years for $200,000; received $200,000 from the operation of the ship during that year; and, a shipping shortage having arisen, assigned the charter in December for $200,000. Mr. Justice Brandeis would have said in the *Ludey* case that one-half of the mine, the motion picture and the ship charter had been sold by being used up; and that one-half of the cost of each should be charged against the income from such use. Not so, says this Court; X paid nothing for the units mined; the year of exhibition of the picture cost Y nothing; Z paid nothing to charter the ship for the first year. All of the cost must be charged against [fol. 109] the one-half of the asset sold in December; none of it against the one-half used up during the year.

2. "All that is required," says this Court, "is a comparison of the asset's selling price with its adjusted basis." "[T]he depreciation allowance is measured by the net cost of the asset to the taxpayer." The "asset costs [the] taxpayer nothing for a year." "[T]he entire cost of the ship had been recovered by the sale."

The trouble with these statements is that they assume the result they are intended to prove. If the whole cost must be charged against the sales price, then, of course, there is no "net cost" left to be deducted from the operating income. But this is not what was done and approved in *Ludey;* the cost was instead allocated partly against operating income and partly against the ultimate sales price. This Court's reasoning is beside the point because it ignores the elementary concept of depreciation.

3. In arriving at this novel result, this Court contradicted 40 years of relevant precedents. Allowance of depreciation in the year of profitable sale of a depreciable asset was approved by the Commissioner of Internal Revenue in published rulings in 1922 (I. T. 1494, I-2 C. B. 19) and 1927 (G. C. M. 1597, VI-1 C. B. 71); by the Board of Tax Appeals in 1927 (*Duncan-Homer Realty Co.,* 6 B. T. A. 730), 1930 (*Herbert Simons,* 19 B. T. A. 711) and 1947 (*Wier Long Leaf Lumber Co.,* 9 T. C. 990); by the Commissioner of Internal Revenue in his 1948 acquiescence in the last decision (1948-1 C. B. 3); by Congressional report in 1950 (H. Rep. No. 3124, 81st Cong., 2d Sess. 29); and by Treasury regulations in 1951 (Reg. 118, § 39.117(g)-2(a)) and 1957 (Reg. § 1.1238-1). One would suppose that in parting company with these and the many other precedents (Pet. Br. 11-35; Pet. Reply [fol. 110] Br. 13-19), this Court would have discussed and repudiated them. But not one is even cited.

4. Having ignored all relevant precedent, this Court asserts that its position is "strongly suggested" by *Cohn* v. *United States,* 259 F. 2d 371 (6th Cir. 1958). We submit that the *Cohn* opinion contains no such suggestion. The Sixth Circuit could not have more explicitly stated that it was not announcing the rule of law which this Court propounds. Drawing from the Government's argument on brief that the District Court's finding of salvage value in *Cohn* "was solely predicated on the facts of this case and, on a different set of facts, it is, of course, possible that an

entirely different finding would result," the Sixth Circuit said that "under the circumstances of this case, we are of the opinion that the District Judge was not in error" and that "his findings of fact with respect to salvage value are . . . not clearly erroneous. . . . " See Merritt, *Government Briefs in Cohn Refute IRS Disallowance of Year-of-Sale Depreciation,* 20 Journal of Taxation 156 (1964). Since the Sixth Circuit adhered to the traditional view that salvage value is the amount realized on sale of an asset "at the end of its useful life" (259 F. 2d at 377), it would not agree with this Court that what petitioner realized on the fortuitous sale of its ship in the middle of useful life was salvage value.

5. What, then, is to be said for this decision? That, although it violates both principle and precedent, it is good tax policy because it protects the revenues? Unfortunately, nothing could be further from the truth:

(a) For the future the revenues are largely protected by sections 1245 and 1250 of the Internal Revenue Code, which, in effect, recapture upon the sale of a depreciable asset at a profit depreciation allowed for [fol. 111] the year of sale and for prior years.* The revenue gain from the decision is, therefore, mainly a transitory one.

---

* Section 1245 treats as ordinary income gain on the sale of personal property and specified real property sold during a taxable year beginning after December 31, 1962 to the extent of depreciation taken for periods after December 31, 1961. Section 1250 treats as ordinary income gain on the sale of real property (other than real property subject to the recapture provisions of section 1245) sold after December 31, 1963 (a) to the extent of depreciation taken for periods after December 31, 1963 if the property was held for one year or less or (b) to the extent of the excess of such depreciation over straight-line depreciation if the property was held for more than a year but for not more than 20 months. The amount treated as ordinary income under (b) is scaled down by one percentage point for each full month over 20 that the property was held.

(b) However, the decision will result in impairment of the revenues where the sale of the depreciable asset is at a loss. Such impairment will occur whenever gains exceed losses under section 1231 of the Internal Revenue Code. Assume, for example, that an asset which has been depreciated at the rate of $100,000 a year is sold at a loss of $300,000, and that in the same year a parking lot is sold at a $400,000 profit. The loss on the sale of the depreciable asset, which would otherwise offset $300,000 of the capital gain on the parking lot, will be converted into a $300,000 depreciation deduction against ordinary income. This sort of revenue impairment will not be transitory, but will continue beyond the enactment of sections 1245 and 1250.

(c) To the limited extent that the decision will continue, following enactment of section 1250, to disallow depreciation on real property for the year of profitable sale, it can be avoided by deferring the sale until early in the succeeding taxable year or by effecting a change of taxable year. See Rev. Rul. 62-92, 1962-1 C. B. 29.

[fol. 112] (d) Sections 1245 and 1250 provide for recapture of depreciation upon the disposition of depreciable property in various transactions in which gain is otherwise not recognized. For example, those sections recapture depreciation on sales at a gain during corporate liquidation under section 337 (as in the present case), on distributions of appreciated property by a corporation in complete liquidation if basis is determined under section 334(a) or 334(b)(2) (as in *Kimball Gas Products Co.* v. *United States*, 63-2 U. S. T. C. ¶ 9507 (W. D. Tex. 1962), on appeal to 5th Cir.); and on distributions of appreciated property by a continuing corporation as described in section 311(a). As to all such dispositions of property worth more than its adjusted basis this Court's decision has become academic. But if the property so disposed of is worth less

than its adjusted basis the result of the decision will be to transmute nonrecognizable loss into deductible increased depreciation.

Thus, concern for the revenue furnishes no basis for the judicial revision of depreciation principles undertaken by this Court. With the gain situations cured by legislation and the loss situations open for exploitation, the decision can only result in mischief.

6. The important question involved in this proceeding is pending in appeals by the United States to three other Circuits, the Fifth, Eighth and Tenth. The three appeals are from District Court decisions which are in conflict with the decision of this Court. *Kimball Gas Products Co.* v. *United States, supra; S & A Co.* v. *United States*, 218 F. Supp. 677 (D. Minn. 1963); *Wyoming Builders, Inc.* v. *United States*, 227 F. Supp. 534 (D. Wyo. 1964). *The Kimball Gas Products Co.* case was argued before the Fifth Circuit on November 14, 1963, and the *S & A Co.* case before the Eighth Circuit on May 14, 1964. There is, [fol. 113] therefore, a strong possibility that the Supreme Court will grant the writ of certiorari which petitioner intends to seek. It would be important for the Supreme Court to have the benefit of the thoughtful appraisal of this Court of the significant legal matters which are not explored in its present decision.

We have respectfully submitted the above matters for the Court's analysis because we are deeply concerned over what we regard as serious errors and omissions in its decision on this important question. The strong dissent by Judge Moore in this case and that of Judge Waterman in *United States* v. *Motorlease Corporation*, Docket No. 28470, show that they share this concern.

The result we seek has virtues which this Court's decision lacks. Our view "safeguards the interests of the Government" as a matter of tax policy and, in adhering to

established principle and precedent, "avoids gratuitous re
sentment in the relations between Treasury and taxpayer.
Rosenman v. *United States,* 323 U. S. 658, 663 (1945).

We respectfully request that these matters be considere
on rehearing, and suggest that it is appropriate that the
be considered by the Court in banc.

Respectfully submitted,

James B. Lewis, 575 Madison Avenue, New Yor
New York 10022, Attorney for Petitioner.

Of Counsel:

Paul, Weiss, Rifkind, Wharton & Garrison.
Michael J. Nassau.

July 28, 1964.

[fol. 114]

Certificate of Counsel

I, James B. Lewis, attorney for petitioner, certify tha
this petition for rehearing is presented in good faith, i
in my opinion well founded and is not filed for the purpos
of delay.

...., James B. Lewi

Dated: New York, N. Y., July 28, 1964.

[fol. 115]

IN THE UNITED STATES COURT OF APPEALS

FOR THE SECOND CIRCUIT

FRIBOURG NAVIGATION COMPANY, INC., Petitioner,

—v.—

COMMISSIONER OF INTERNAL REVENUE, Respondent.

Before: Swan, Moore and Smith, C.JJ.

RULING ON PETITION FOR REHEARING AND FOR STAY OF MANDATE

Motion for rehearing denied.

TWS by LPM, LPM, JJS by LPM, U.S.C.JJ.

August 7, 1964.

Motion for stay of mandate, subject to conditions of Rule 28(c) of this Circuit, granted.

TWS by LPM, LPM, JJS by LPM, U.S.C. JJ.

August 19, 1964.

[fol. 116] [File endorsement omitted]

[fol. 117]

IN THE UNITED STATES COURT OF APPEALS

SECOND CIRCUIT

Present: Hon. Thomas W. Swan, Hon. Leonard P. Moore, Hon. J. Joseph Smith, Circuit Judges.

[Title omitted]

ORDER DENYING PETITION FOR REHEARING, ETC. —August 20, 1964

A petition for a rehearing together with a motion for a stay of the issuance of mandate pending application for a writ of certiorari to the Supreme Court of the United States having been filed herein by counsel for petitioner,

Upon consideration thereof, it is

Ordered that said petition for a rehearing be and hereby is denied.

Further ordered that the motion to stay issuance of the mandate be and it hereby is granted subject to the provisions of Rule 28(c) of the rules of this court.

[fol. 118] [File endorsement omitted]

[fol. 119]

In the United States Court of Appeals

For the Second Circuit

[Title omitted]

Ruling on Petition for Rehearing In Banc —August 19, 1964

James B. Lewis, New York, N. Y., for petitioner.

As no active circuit judge has requested that this case be reheard in banc, and as Judge Swan, who is qualified to vote thereon by virtue of 28 U. S. C. §43 votes to deny, the petition is denied.

J. Edward Lumbard, Chief Judge.

[fol. 120] [File endorsement omitted]

[fol. 121]

IN THE UNITED STATES COURT OF APPEALS

SECOND CIRCUIT

Present: Hon. J. Edward Lumbard, Chief Judge, Hon. Thomas W. Swan, Hon. Sterry R. Waterman, Hon. Leonard P. Moore, Hon. Henry J. Friendly, Hon. J. Joseph Smith, Hon. Irving R. Kaufman, Hon. Paul R. Hays, Hon. Thurgood Marshall, Circuit Judges.

[Title omitted]

ORDER DENYING PETITION FOR REHEARING IN BANC —August 20, 1964

A petition for a rehearing in banc having been filed herein by counsel for the petitioner,

Upon consideration thereof, it is

Ordered that said petition be and hereby is denied.

[fol. 122] [File endorsement omitted]

[fol. 123] Clerk's Certificate to foregoing transcript (omitted in printing).

[fol. 124]

SUPREME COURT OF THE UNITED STATES

No. 679, October Term, 1964

FRIBOURG NAVIGATION COMPANY, INC., Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE.

ORDER ALLOWING CERTIORARI—February 1, 1965

The petition herein for a writ of certiorari to the United States Court of Appeals for the Second Circuit is granted, and the case is placed on the summary calendar.

And it is further ordered that the duly certified copy of the transcript of the proceedings below which accompanied the petition shall be treated as though filed in response to such writ.

FILE COPY

Office-Supreme Court,
FILED
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JOHN F. DAVIS, CLE

IN THE

Supreme Court of the United States

OCTOBER TERM, 1964

No. [redacted] 23

FRIBOURG NAVIGATION COMPANY, INC.,
Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

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INDEX

TABLE OF CITATIONS

PAGE

CASES:

IN THE

Supreme Court of the United States

OCTOBER TERM, 1964

FRIBOURG NAVIGATION COMPANY, INC., *Petitioner,* *v.* COMMISSIONER OF INTERNAL REVENUE, *Respondent.*	No.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

Petitioner prays that a writ of certiorari issue to review the judgment of the United States Court of Appeals for the Second Circuit.

OPINIONS BELOW

The opinion of the Court of Appeals (R. 87a-94a), Judge Moore dissenting (R. 94a-104a), is reported at 335 F. 2d 15 (2d Cir. 1964) and is reprinted in Appendix A, *infra,* pp. 1a-19a.* The memorandum opinion of the Tax Court (R. 3a-22a) is not officially reported, but is unofficially reported at 21 CCH T. C. Memo. 1533 (1962) and at 1962 P-H T. C. Memo. ¶ 62,290.

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*References to "R." are to the certified transcript of the record in this case, which includes the printed Appendix to Petitioner's Brief in the Court of Appeals. For the convenience of the Court, we have filed nine additional copies of that Appendix, the pages of which are numbered the same as the corresponding portion of the certified transcript.

JURISDICTION

The judgment of the Court of Appeals (Appendix A, *infra,* p. 20a) was entered on July 15, 1964. (R. 105a-106a.) An order of the Court of Appeals denying a timely petition for rehearing and granting a timely motion to stay issuance of its mandate (Appendix A, *infra,* p. 21a) was entered on August 20, 1964. (R. 117a.) The jurisdiction of this Court is invoked under 28 U. S. C. § 1254(1).

QUESTION PRESENTED

Whether, as a matter of law, the sale of depreciable property for an amount in excess of its depreciated cost at the beginning of the year of sale necessarily bars the deduction of depreciation on the property for the period of its use during that year.

STATUTE AND REGULATIONS INVOLVED

The statute involved is section 167(a) of the Internal Revenue Code of 1954, 26 U. S. C. § 167(a), which provides:

> SEC. 167 DEPRECIATION.
>
> (a) GENERAL RULE.—There shall be allowed as a depreciation deduction a reasonable allowance for the exhaustion, wear and tear (including a reasonable allowance for obsolescence)—
>
> (1) of property used in the trade or business, or
>
> (2) of property held for the production of income.

The regulations involved are sections 1.167(a)-1, 1.167(a)-9 and 1.167(a)-10 of the Income Tax Regula-

tions (26 C. F. R. §§ 1.167(a)-1, 1.167(a)-9 and 1.167(a)-10), pertinent portions of which are reprinted in Appendix B, *infra,* pp. 1b-5b.

STATEMENT OF THE CASE

The material facts in this case are undisputed and are as follows:

Petitioner, a Delaware corporation organized in 1946, owned and operated ships for charter to others for the carriage of cargoes in foreign commerce. (R. 4a.) On December 21, 1955, petitioner purchased the *S.S. Joseph Feuer* (the *"Feuer"*), a Liberty-type dry cargo ship, for $469,000. (R. 4a.) Petitioner operated the *Feuer* under the American flag as a tramp ship for the carriage of various dry cargoes from the United States to Asian and African ports. (R. 9a.)

The *Feuer* had been built in 1943 for emergency use during World War II. (R. 4a.) In postwar commerce Liberty ships carried low-paying bulk commodities, principally grain and coal. (R. 10a.) Being slow and of low cargo capacity and facing mounting competition from more modern ships, Liberty ships were rapidly becoming obsolete. (R. 9a-10a, 13a.)

Before purchasing the *Feuer,* petitioner applied for and received a letter ruling from respondent's office, dated December 8, 1955, with respect to its depreciation. (R. 4a.) The ruling stated that the Internal Revenue Service would accept a useful economic life of three years from the date of acquisition and a salvage value of $5 per dead weight ton ($54,000) for the *Feuer.* (R. 4a-5a.) The ruling further stated that the *Feuer's* cost of $469,000, less its $54,000 salvage value, should be spread ratably over its three-year useful economic life. (R. 5a.)

Petitioner claimed deductions for depreciation of the *Feuer* for the 10-day period of its use during 1955 and the entire year 1956 as provided by the ruling. (R. 5a-6a.) The Internal Revenue Service audited petitioner's income tax returns for those two years and accepted the depreciation deductions without adjustment. (R. 6a.) The depreciated cost of the *Feuer* as of the beginning of 1957 was \$326,627.73. (R. 6a.)

The economic and market conditions resulting from the blockage of the Suez Canal in 1956-1957 temporarily inflated charter rates and ship prices. (R. 6a-7a.) As a result, the *Feuer* appreciated in value. (R. 7a.) In June of 1957 Isbrandtsen Company, Inc. ("Isbrandtsen"), one of petitioner's competitors, offered an excellent price for the *Feuer*, which petitioner accepted. (R. 7a.) On June 14, 1957, petitioner entered into a contract for the sale of the *Feuer* to Isbrandtsen for \$700,000 (which price was subsequently reduced to \$695,000 in connection with a change in financing). (R. 7a-8a.) The contract called for delivery of the *Feuer* to Isbrandtsen in December of 1957, and petitioner made delivery on December 23, 1957. (R. 7a-8a.)

Petitioner had not followed a practice of using ships for a short time and then reselling them while still in good operating condition. (R. 8a, 17a.) Petitioner had not put the *Feuer* up for sale, but decided to sell it because Isbrandtsen had offered an excellent price. (R. 7a.) The contract of sale was entered into halfway through the three-year useful economic life established for the *Feuer* by the ruling letter (R. 7a), and when the *Feuer* was delivered to the purchaser one-third of that useful life remained. (R. 8a.)

Conditions at the end of 1957, when the *Feuer* was delivered to the purchaser, tended to confirm the correctness of the forecasts of useful economic life and salvage value made in the ruling letter. Charter rates had fallen

sharply (R. 10a-11a), competition for dry bulk cargoes was increasing (R. 10a, 12a), Liberty ships were finding it harder to secure cargoes (R. 12a-13a), and prices of such ships were falling (R. 13a), all of which confirmed the *Feuer's* obsolescence. Scrap steel prices were also falling, and the scrap value of a Liberty ship was between $53,000 and $60,000 (R. 13a), almost exactly as established by the ruling letter.

In its 1957 tax return, petitioner reported gross profit of $289,340 from the operation of the *Feuer* up to the date of sale. (R. 8a-9a.) Petitioner also deducted $135,367.24 for depreciation of the *Feuer* during the period of such operation, under the formula authorized by the ruling letter and used and approved for prior years. (R. 5a, 8a.) Respondent has never questioned the originally established three-year useful economic life for the *Feuer* (R. 17a) nor changed the ruling letter as to such useful life or as to salvage value. (R. 6a.) Nevertheless, respondent completely disallowed the 1957 depreciation deduction (R. 8a), and defended such disallowance on the sole ground that, as a matter of law, the profitable sale of the *Feuer* barred any depreciation deduction for the year of sale. (R. 14a.)

The Tax Court sustained respondent's disallowance. (R. 2a-22a.) The Court of Appeals affirmed (R. 87a-94a), Judge Moore dissenting (R. 94a-104a).

REASONS FOR GRANTING THE WRIT

I. The Question Is One of General Importance Which Is Being Widely Litigated, and Will Continue To Be So Litigated Until It Is Authoritatively Settled.

The eleven million business taxpayers in the United States[1] own an immense quantity of equipment, machinery,

[1]Statistics of Income—1961-62, U. S. Business Tax Returns, United States Government Printing Office (1964), Table A.

buildings and other depreciable property. Their depreciation deductions exceed $32 billion annually, and the depreciable assets of corporate taxpayers alone exceed $450 billion.[2] Every day a portion of this huge volume of depreciable property is sold, frequently at a profit in this postwar era of rising price levels. The decision below threatens a vast number of taxpayers with denial of any depreciation deduction for the year of profitable sale of their depreciable assets.

From the inception of the income tax law until very recently—a period of almost 50 years—everyone, including respondent, agreed that depreciation was allowable for the year of profitable sale.[3] Respondent has recently attempted to overthrow this well-established rule,[4] and large numbers of taxpayers have resisted. A large volume of litigation has resulted, which will continue to swell until the right to depreciation in the year of sale—currently the most widely important disputed issue of income tax law—is authoritatively settled.

The Tax Court and five United States District Courts have already considered respondent's change of position in cases involving depreciation of a variety of assets—rental housing projects, office buildings, shopping centers, automobiles, manufacturing plants, and machinery and equipment—as well as petitioner's Liberty ship. Five of these six trial courts have expressly rejected that change of position and adhered to the traditional view that depreciation is allowable in the year of profitable sale of the asset.

Most dramatically, the Tax Court has just decided, after a close scrutiny of respondent's new position, that it is "incorrect" and fails "to comply with the underlying

[2]*Id.*, Tables A and 27.

[3]See pp. 9-12, *infra*.

[4]See pp. 12-13, *infra*.

intent of section 167 and the specific provisions of his own regulations thereunder." *Macabe Company, Inc.*, 42 T. C. —, No. 87 (September 29, 1964).[5] Earlier, in two unreviewed decisions by single judges, the Tax Court had accepted respondent's change of position. *Randolph D. Rouse,* 39 T. C. 70 (1962), and the instant case. However, in *Macabe,* which was reviewed by the entire Court, the Tax Court said it "decline[d] to follow" its decision in *Rouse* and disagreed with "the rationale relied upon by a majority of the panel" of the Second Circuit in the instant case. 42 T. C. at p. —, CCH Tax Ct. Rep., Dec. 26,982, at pp. 3025, 3029; ¶ 42.87 P-H TC, at pp. 806-42, 810-42.[6]

Four of the five District Courts which have considered respondent's new position have also rejected it. *Motorlease Corporation* v. *United States,* 215 F. Supp. 356 (D. Conn. 1963), *rev'd,* 334 F. 2d 617 (2d Cir. 1964),[7] cert.

[5]The current Tax Court position is further refined in *Smith Leasing Co.,* 43 T. C.—, No. 5 (October 20, 1964), and *Palmaneda Adams,* T. C. Memo. 1964-286, CCH T. C. Memo. 1743, 1964 P-H T. C. Memo. ¶ — (October 30, 1964).

[6]The *Macabe* opinion, though rejecting the rationale of the majority below, suggested that the Tax Court decision in the instant case could be justified on the ground that petitioner failed to prove its depreciation allowance had not been excessive. However, in sustaining respondent in the instant case, the Tax Court relied wholly on the principle announced in the *Rouse* case "that a depreciation deduction is not allowable for the year in which an asset is sold where the sales price of such asset is in excess of the asset's undepreciated cost as of the beginning of the year of sale," and found "the *Rouse* case . . . dispositive of the question presented." (R. 21a-22a.) The Tax Court found below that petitioner's estimate of useful life was "not questioned," and that petitioner's "extensive evidence in support of its original estimate of salvage value" established a scrap value for Liberty ships at the end of 1957 of "between $53,000 and $60,000"—figures in line with the original $54,000 estimate of salvage value and far below the *Feuer's* adjusted basis at the beginning of the year of sale. (R. 17a.)

[7]This two-to-one reversal of the District Court was dissented to by Judge Waterman on the grounds stated by Judge Moore in his dissent in the instant case.

applied for; *Kimball Gas Products Co.* v. *United States,* 63-2 U. S. T. C. ¶ 9507, 12 A. F. T. R. 2d 5105 (W. D. Tex. 1962), on appeal to 5th Cir.; *S & A Co.* v. *United States,* 218 F. Supp. 677 (D. Minn. 1963), on appeal to 8th Cir.; *Wyoming Builders, Inc.* v. *United States,* 227 F. Supp. 534 (D. Wyo. 1964), on appeal to 10th Cir.; *contra, Killebrew* v. *United States,* 64-2 U. S. T. C. ¶9728, 14 A. F. T. R. 2d 5565 (E. D. Tenn. 1964).

Appeals by the Government from the adverse District Court decisions in the *Kimball Gas Products Co., S & A Co.* and *Wyoming Builders, Inc.* cases are pending in the Fifth, Eighth and Tenth Circuits, respectively,[8] and we understand that respondent intends to petition the Ninth Circuit for review of the Tax Court's adverse decision in *Macabe Company, Inc.* Similar cases are pending in several other District Courts, and many additional cases are being held in reserve administratively until the issue is definitely resolved.

The overwhelming weight of contemporaneous adjudication thus rejects respondent's recent change of position, but the majority opinion below gives it sufficient support to obstruct disposition of the numerous pending cases. A prompt decision by this Court is essential to avoid a prolonged period of uncertainty and dispute, both for the large number of taxpayers with pending tax controversies for prior years, and for taxpayers who currently must prepare income tax returns for the year of sale of depreciable property.[9] Unneces-

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[8]The *Kimball Gas Products, Inc.* case was argued before the Fifth Circuit on November 14, 1963 and the *S & A Co.* case before the Eighth Circuit on May 14, 1964.

[9]The issue presented here is of continuing importance for current and future taxable years except where the increased gain attributable to depreciation for the year of sale is taxable as ordinary income. Section 1245, added to the Internal Revenue Code in 1962, provides prospectively for such ordinary income treatment in the case of personal property only. With respect to real estate, the question

sary delay in the disposition of this issue will result in the expiration of statutes of limitations applicable to a host of taxpayers who lack the financial resources to resist respondent's position.

II. The Decision Below Conflicts in Principle and Result with Decisions of This Court and Discards Long-Established Construction and Practice.

The decision of the Court of Appeals contradicted a vast body of precedent, including decisions of this Court, lower court decisions, administrative rulings and practice, and indicia of Congressional intent.

A. The Long-Standing Precedents

In *Eldorado Coal & Mining Co.* v. *Mager,* 255 U. S. 522 (1921), this Court sustained an assessment arrived at by "subtracting depreciation and depletion to the date of sale" of a coal mine in May of 1917 and computing profit on the sale accordingly. Again, in *United States* v. *Ludey,* 274 U. S. 295 (1927), this Court upheld a determination of gain on the sale of properties arrived at by deducting depreciation and depletion to the date of their sale in February of 1917 and adjusting the bases of the properties accordingly. In each of these cases respondent allowed depreciation on property in the year of its profitable sale and, with approval of this Court, adjusted the basis of the property for such depreciation in determining the profit on the sale.[10]

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whether depreciation should be allowed for the year of sale remains of prime importance. Section 1250, added to the Internal Revenue Code in 1964, generally provides that only the excess of accelerated depreciation over straight line depreciation shall be treated as ordinary income on the sale of real estate, and even such excess is freed from such treatment under a scale related to the period the property was held.

[10] This is also the business accounting practice. Paton, Accountants Handbook 685 (note 45), 742, 773, 777 (3d Ed. 1944); 1 Dewing, The Financial Policy of Corporations 581, note 39 mmm (5th Ed.

Respondent's long-established practice of allowing depreciation on properties in the year of their profitable sale is reflected in many other court decisions. *Kittredge* v. *Commisssioner,* 88 F. 2d 632 (2d Cir. 1937); *Beckridge Corporation* v. *United States,* 129 F. 2d 318 (2d Cir. 1942); *Clark Thread Co.* v. *Commissioner,* 100 F. 2d 257 (3d Cir. 1938); *Hall* v. *United States,* 43 F. Supp. 130 (Ct. Cl.), *cert. denied,* 316 U. S. 664 (1942); *Grosvenor Atterbury,* 1 B. T. A. 169 (1924); *Even Realty Co.,* 1 B. T. A. 355 (1925); *W. W. Carter Co.,* 1 B. T. A. 849 (1925); *Star Sporting Goods Co.,* 1 B. T. A. 1266 (1925); *Keighley Mfg. Co.,* 2 B. T. A. 10 (1925); *Marchetti Roma Cafe Co.,* 2 B. T. A. 529 (1925); *Walter Frank,* 2 B. T. A. 905 (1925); *Cotton Concentration Co.,* 4 B. T. A. 121 (1926); *Capital City Investment Co.,* 4 B. T. A. 933 (1926); *Island Line Shipping Co.,* 4 B. T. A. 1055 (1926); *Seton Falls Realty Co.,* 6 B. T. A. 883 (1927); *Parkersburg & Marietta Sand Co.,* 11 B. T. A. 87 (1928); *Louis Kalb,* 15 B T. A. 865 (1929); *Franklin Lumber & Power Co.,* 18 B. T. A. 1207 (1930), *rev'd on other grounds,* 50 F. 2d 1059 (4th Cir. 1931).

In 1930, at the insistence of respondent, the Board of Tax Appeals expressly held that depreciation had to be taken by the taxpayer in the year of sale of the depreciable property at a profit. *Herbert Simons,* 19 B. T. A. 711 (1930).[11] The Tax Court again so held in 1947, this time

1953). This Court has recognized that the income tax allowance is for depreciation as "charged in practical bookkeeping." *Stratton's Independence, Ltd.* v. *Howbert,* 231 U. S. 399, 423 (1913); *Von Baumbach* v. *Sargent Land Co.,* 242 U. S. 503, 524 (1917); *cf. Real Estate Title Co.* v. *United States,* 309 U. S. 13, 16 (1940).

[11]Since the taxpayer in the *Simons* case had deductions in excess of his ordinary income but insufficient to wipe out the capital gain on the sale, he would have paid a lower tax by not taking the depreciation.

at the urging of the taxpayer, in the only case up to that time in which respondent had attempted to disallow depreciation for the year of sale. *Wier Long Leaf Lumber Co.*, 9 T. C. 990, 999 (1947), *aff'd and rev'd on other issues*, 173 F. 2d 549 (5th Cir. 1949). Respondent promptly acquiesced in this adverse decision. 1948-1 C. B. 3.[12]

The Third Circuit has held, *Rieck* v. *Heiner*, 25 F. 2d 453, 454 (3d Cir.), *cert. denied*, 277 U. S. 608 (1928), that "in computing the gain from a sale of property a deduction of depreciation during the period of operation shall be made." Similarly, the Eighth Circuit has held, *Forrester Box Co.* v. *Commissioner*, 123 F. 2d 225, 229 (8th Cir. 1941), that a taxpaper who sold machinery and equipment on July 1, 1929 should have "an opportunity to show what the allowable depreciation on the machinery and equipment was from the time it acquired it up to July 1, 1929."

Respondent's rulings reflect the same approach toward allowance of depreciation. In 1922 respondent approved depreciation of property to $40,000 in the year of its sale for $47,000. I. T. 1494, I-2 C. B. 19, 20-21. He again approved depreciation in the year of profitable sale in rulings issued in 1924 (A. R. R. 6930, III-1 C. B. 45) and 1927 (G. C. M. 1597, VI-1 C. B. 71), and by publication in 1928 of the decision of the Third Circuit in *Rieck* v. *Heiner*, *supra* (VII-1 C. B. 200).

In the light of the above decisions and rulings and the administrative practice reflected in them, Congress repeatedly reenacted the depreciation statute without relevant

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[12]The purpose of acquiescence is to furnish taxpayers assurance that they can rely upon the disposition of the issue "without the danger of being forced to litigate the same question in their own cases." *Stockstrom* v. *Commissioner*, 190 F. 2d 283, 284 (D. C. Cir. 1951).

change.[13] Ample evidence of Congressional knowledge of the subject is found in its legislative actions. In 1942 Congress liberalized capital gains treatment for depreciable property.[14] In 1947-1948, in 1950, and in 1954 Congress failed to act on recommendations for recoupment of depreciation as ordinary income on sale of the property.[15] The Conference Report on the Revenue Act of 1950 contained an example specifically illustrating the allowance of $500 of depreciation in the year of sale of a facility at a $500 profit.[16] The Treasury Department has incorporated this example of such allowance in its income tax regulations since 1951.[17]

This body of court decisions, published rulings, administrative practice and acquiescence, statutory reenactment, Congressional statements and Treasury regulations created a sense of repose which respondent and the Second Circuit have only recently interrupted. On June 7, 1962, the day before the trial of this case in the Tax Court, respondent announced for the first time that he would no longer allow depreciation for the year of profitable sale of the depreciable asset.[18] This announcement brought into

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[13]Rev. Acts of 1921, 1924 and 1926, § 214(a)(8); Rev. Acts of 1928 and 1932, § 23(k); Rev. Acts of 1934, 1936 and 1938, § 23(1); Int. Rev. Code of 1939, § 23(1); Int. Rev. Code of 1954, § 167(a).

[14]Int. Rev. Code of 1939, § 117(j), added by Rev. Act of 1942, § 151(b); now Int. Rev. Code of 1954, § 1231.

[15]Hearings before the Committee on Ways and Means, House of Representatives, 80th Cong., 1st Sess. on Revenue Revisions 1947-48, Part 5, p. 3756; statement of Senator Milliken at 96 Cong. Rec. 14057 (1950); Hearings before the Committee on Finance, United States Senate, 83d Cong., 2d Sess. on H. R. 8300, Part 3, p. 1324 (1954).

[16]H. Rep. No. 3124, 81st Cong., 2d Sess. 29 (1950).

[17]Reg. 118, § 39.117(g)-2, added by T. D. 5851, 1951-2 C. B. 63, 73. The example now appears in Reg. § 1.1238-1, issued in 1957 by T. D. 6253, 1957-2 C. B. 547, 562-563.

[18]Treasury Information Release 374, dated June 7, 1962. In 1962-26 I. R. B., dated June 25, 1962, respondent reissued this release as Rev. Rul. 62-92, 1962-1 C. B. 29, and withdrew his acquiescence in *Wier Long Leaf Lumber Co., supra,* 1962-1 C. B. 5.

the open what taxpayers had been gradually discovering upon audit, for respondent had privately instructed his agents a year or more earlier that they should commence disallowing such depreciation. Through this breach with precedent the large volume of pending cases was accumulated.

Against respondent's "prior longstanding and consistent administrative interpretation"— as repeatedly reflected and approved in decisions of this Court and many lower courts—his "more recent *ad hoc* contention as to how the statute should be construed cannot stand." *United States* v. *Leslie Salt Co.,* 350 U. S. 383, 396 (1956).

B. *Cohn* v. *United States*

In departing from the long-standing position which we have just described, the Second Circuit said only that its opinion was "strongly suggested" by the opinion of the Sixth Circuit in *Cohn* v. *United States,* 259 F. 2d 371 (6th Cir. 1958), and cited no other authority whatever. (R. 90a.) The Second Circuit took this radical step even though it recognized that *Cohn* had been "variously construed" and "could have been more explicit," and even though it thought respondent's construction of the *Cohn* decision was "perhaps logically inconsistent." (R. 90a-91a.) Unfortunately, the decision below so completely misunderstands the *Cohn* decision as to conflict with it in principle.

Respondent disclaimed in *Cohn*—and the Sixth Circuit certainly did not propound—the sweeping proposition of law asserted by the Second Circuit in its opinion below. In *Cohn* (a) the taxpayers had failed to set up any salvage value although it was clear that they should have done so, (b) both useful life and salvage value were in controversy for all years from the beginning of the use of the assets, and (c) the assets were sold "at or near the end of the useful life" determined by the District Court. 259 F. 2d at 373-375, 378. The Government, far from arguing any issue of

law, said on brief in *Cohn* that the District Court's finding that the salvage value of such assets equalled their sales price "was solely predicated on the facts of this case and, on a different set of facts, it is, of course, possible that an entirely different finding would result."[19] The Sixth Circuit, accepting this statement, said merely that "under the circumstances of this case, we are of the opinion that the District Judge was not in error" and that "his findings of fact with respect to salvage value are . . . not clearly erroneous." 259 F. 2d at 379.

As a narrow factual holding, the *Cohn* decision follows the great body of precedent which the Second Circuit has chosen to ignore.[20] In treating sales price as evidence of salvage value where the sale was at the end of useful life, it adheres to the traditional view that salvage value is the amount expected to be realized at the end of useful life and is not the amount realized at any other time.

The Tax Court and the District Courts which have rejected respondent's recent break with that body of precedent agree with us that *Cohn* does not aid him.[21] The *Cohn* opinion was briefed before this Court in *Massey Motors, Inc.* v. *United States,* 364 U. S. 92 (1960), and is well summarized in Mr. Justice Harlan's dissenting opinion (364 U. S. at 117-118); yet, as we note below, (a) this Court allowed depreciation on a number of automobiles in the year of their profitable sale and (b) Mr. Justice Harlan observed that not even respondent contended that depreciation must be keyed to the fortuitous sale of an asset in the middle of its useful life.[22]

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[19] Appellee's Brief, p. 32, in *Cohn* v. *United States, supra.* See Merritt, *Government Briefs in Cohn Refute IRS Disallowance of Year-of-Sale Depreciation,* 20 Journal of Taxation 156 (1964).

[20] See pp. 9-12, *supra.*

[21] *Macabe Company, Inc., supra,* CCH Tax Ct. Rep., Dec. 26, 982, at pp. 3028-3029, ¶ 42.87 P-H TC, at pp. 42-809, 810-42; *Motorlease Corporation* v. *United States, supra,* 215 F. Supp. at 361-364; *S & A Co.* v. *United States, supra,* 218 F. Supp. at 683-684; *Wyoming Builders, Inc.* v. *United States, supra,* 227 F. Supp. at 538.

[22] See p. 15, *infra.*

Therefore, the opinion below stands alone—without support from *Cohn*—in contradicting the long-standing precedents allowing depreciation in the year of profitable sale. Because of the widespread importance of this question, the conflict created by the decision below on an issue otherwise long settled requires resolution by this Court.

III. Certiorari Should Be Granted To Prevent Further Misconstruction of this Court's Decision in *Massey Motors, Inc.* v. *United States*, 364 U. S. 92 (1960).

In *Massey Motors, Inc.* v. *United States, supra,* this Court, consistently with its actions in the *Eldorado Coal* and *Ludey* cases,[23] approved depreciation allowances for automobiles for the year of their resale which brought their depreciated cost below their resale price.[24] "Had the Supreme Court wished to declare the principle now urged by the Commissioner," observed Judge Moore in his dissent below, "it had every opportunity to do so merely by taking the actual sales price. However, it did not." (R. 99a.) Mr. Justice Harlan emphasized in his dissenting opinion in *Massey* that "even the Commissioner does not contend that a taxpayer who *happens* to dispose of some asset before its physical exhaustion must depreciate it on a useful life equal to the time it was actually held." 364 U. S. at 113.[25] This Court's decision in *Massey* is, therefore, inconsistent in result with the novel doctrine that depreciation

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[23] See p. 9, *supra*.

[24] The *Massey* decision, by reversing *Evans* v. *Commissioner*, 264 F. 2d 502 (9th Cir. 1959), approved depreciation allowances which reduced to $1,325 the depreciated cost of 140 automobiles which were sold in the same year for an average price of $1,380. 364 U. S. at 94-95; 264 F. 2d at 504-505.

[25] Emphasis in original.

should be disallowed for the year of profitable sale, and was decided with awareness that not even respondent subscribed to that doctrine. Nevertheless, respondent has based his change of position, as set forth in Rev. Rul. 62-92, *supra*, and his briefs in the cases in which that change has been in issue, on this Court's decision in *Massey*.[26]

This Court held in *Massey* that where the "experience" of the taxpayer establishes that assets "are not acquired with intent to be employed in the business for their full economic life," their "useful life" and "salvage value" must be related to such experience. 364 U. S. at 96-97, 107. Only thus can there be "a meaningful allocation of the cost entailed in the use . . . of the asset to the periods to which it contributes." 364 U. S. at 104. This system of accounting for depreciation "has had the approval of this Court since *United States* v. *Ludey*, 274 U. S. 295, 301 (1927), when Mr. Justice Brandeis said, 'The theory underlying this allowance for depreciation is that by using up the plant, a gradual sale is made of it.' " *Ibid.* Mr. Justice Brandeis added in *Ludey* that depreciation is the "measure of the cost of the part" that has been "sold" by being used, and approved the depreciation formula by which the "original cost" less "salvage value" is spread evenly over the plant's expected "useful life." 274 U. S. at 301.

Under the perceptive analysis in the *Ludey* and *Massey* cases, the depreciated cost of the *Feuer* as of January 1, 1957 must be allocated partly against its operating income for 1957 and partly against the sales price received in December of that year. Respondent and the Second Circuit, disregarding Mr. Justice Brandeis's allocation formula, have charged the cost remaining on January 1, 1957 wholly

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[26] See, *e.g.*, Respondent's Brief in the Second Circuit in the instant case, pp. 9, 13-16, 18-19, 31, 39. See also the Tax Court's reliance on *Massey* in the instant case. (R. 14a-15a, 20a-21a, 22a.)

against the portion of the asset sold in December and nothing against the portion used up during the year. By rejecting the "meaningful allocation" of cost which this Court has approved, the Second Circuit has caused petitioner's income from operation of the *Feuer* to be heavily overtaxed.

Respondent is now applying his misconstruction of the *Massey* decision to countless taxpayers throughout the country to create a prolonged and inconclusive series of litigations. Only this Court can set the matter at rest.

CONCLUSION

For the foregoing reasons the petition for a writ of certiorari should be granted.

Respectfully submitted,

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November 17, 1964.

APPENDIX A

Opinion of the Court of Appeals

UNITED STATES COURT OF APPEALS

FOR THE SECOND CIRCUIT

No. 72—September Term, 1963.

(Argued January 16, 1964 Decided July 15, 1964.)

Docket No. 28165

FRIBOURG NAVIGATION COMPANY, INC.,
Petitioner,

—v.—

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

BEFORE:

SWAN, MOORE and SMITH,
Circuit Judges.

Petition to review a decision of the Tax Court of the United States, Marion J. Harron, *J.*, upholding disallowance of a depreciation deduction for taxable year in which an asset was sold for more than its depreciated cost. 39 T. C. Memo. 1962-290. Affirmed.

JAMES B. LEWIS, New York, N. Y. (Theodore Ness, Michael J. Nassau and Paul, Weiss, Rifkind, Wharton & Garrison, New York, N. Y., on the brief), *for petitioner.*

WILLIAM A. FRIEDLANDER, Attorney, Dept. of Justice, Washington, D. C. (Louis F. Oberdorfer, Asst. Atty. General, Lee A. Jackson and Harry Baum, Dept. of Justice, Washington, D. C., on the brief), *for respondent.*

SMITH, *Circuit Judge*:

The sole issue presented by this appeal is whether a taxpayer is entitled to a depreciation deduction for the year in which a depreciable asset is sold at more than its depreciated cost. The Tax Court sustained the Commissioner's disallowance of the deduction, and the taxpayer has appealed to this court. We agree with the Tax Court's determination and affirm the judgment.

The taxpayer, Fribourg Navigation Co., operated two cargo ships in foreign commerce. One of these was the *S.S. Feuer,* a Liberty ship purchased in December of 1955 for $469,000. Just prior to purchasing the *Feuer*, the taxpayer secured a letter ruling from the Engineering and Valuation Branch of the Internal Revenue Service advising that it would accept straight line depreciation of the ship over a useful economic life of three years, subject to change if warranted by subsequent experience. The letter ruling also advised that the Internal Revenue Service would accept a salvage value of $54,000 on the *Feuer*. This estimate of the *Feuer's* useful economic life and salvage value, concededly reasonable in December of 1955, was thrown out of kilter by a scarcity of ships resulting from the Suez Crisis of 1956-57, which sharply inflated the values of ships normally considered obsolete. In June of

1957 the taxpayer accepted an offer to sell the *Feuer* for $700,000, $231,000 more than it had paid for the ship a year and a half before. When the *Feuer* was delivered to its new owner on December 23, 1957, the contract terms were slightly modified, reducing the purchase price to $695,500.

Relying on the letter ruling, the taxpayer deducted the $54,000 estimated salvage value from the $469,000 cost and spread the $415,000 equally over a three year useful life—from December 21, 1955 to December 21, 1958. This resulted in a daily depreciation of about $378.65. On its income tax returns, the taxpayer claimed the following depreciation deductions for the *Feuer*:

Calendar Year	Period of Ownership	Depreciation
1955	10 days	$ 3,786.50
1956	366 days	138,585.77
1957	357½ days	135,367.24
	Total	$277,739.51

On March 7, 1957, prior to the sale of the *Feuer*, the taxpayer adopted a plan of complete liquidation, which was carried out within 12 months. Since the liquidation came within the sanctuary of Section 337 of the Internal Revenue Code, the taxpayer incurred no tax liability on the capital gain from the sale of the *Feuer*. For information purposes only, the taxpayer reported a capital gain of $504,239.51 (the difference between the selling price and the adjusted basis after taking a depreciation allowance for 357½ days of 1957). The taxpayer reported a gross income (after cost of operations) of $391,811.31 in 1957.

This was reduced to $141,193.35 after deductions of $250,-617.96, including $135,367.24 for the depreciation of the *Feuer* in 1957.

The Commissioner disallowed the $135,367.24 deduction in full, taking the position that a taxpayer cannot depreciate an asset during the year its sale reveals that it has not depreciated. At the start of 1957 the *Feuer* had an adjusted basis of $326,627.73. In December of 1957 it was sold for $695,500. The Commissioner claims Congress never intended to permit further depreciation under such circumstances, and that a depreciation deduction claimed when the taxpayer knows with certainty that the asset has appreciated rather than depreciated must be disallowed as unreasonable. The Commissioner does not seek to recapture the depreciation deductions allowed for 1955 and 1956. He is content with contending only that depreciation disallowance should be limited to the year in which an asset is sold for more than its adjusted basis.

Though perhaps logically inconsistent, this position is strongly suggested by the opinion of the Sixth Circuit in *Cohn* v. *United States,* 259 F. 2d 371 (1958), which first permitted the Commissioner to disallow depreciation deductions on assets sold for more than their adjusted basis. In 1941-42 the taxpayers in *Cohn* began to operate three flying schools to train pilots under the Army Air Corps Contract Flying School Program. The taxpayers determined that their contracts for operation of the schools would terminate at the end of 1944, and the equipment they had purchased to operate the schools should be depreciated over a useful economic life ending on December 31, 1944. In computing their depreciation deductions, the taxpayers neglected to place any salvage value on the

equipment, though operators of similar flying schools used an estimated salvage value of ten percent in establishing their depreciation schedules. One of the schools ceased its operations on August 4, 1944, and its equipment was sold at auction during that month. The property of the other two schools was auctioned off in November of 1944. Because of wartime shortages, the equipment brought substantial sums, exceeding the adjusted basis of the assets at the beginning of 1944. The Commissioner disallowed the depreciation deductions for all the years as excessive and unreasonable. The District Court found that a salvage value of 10% of the original cost should have been used in computing the depreciation schedules and that the actual sales price should have been substituted for the salvage value in the year in which the asset was sold. Only the latter holding was appealed to the Sixth Circuit, which affirmed the District Court.

The holding of *Cohn* has been variously construed. Some have taken a very narrow view, reading *Cohn* as holding only that on the peculiar facts the District Court's finding that the salvage value should be redetermined in the year of the assets' sale to reflect the sales price was not clearly erroneous. Others have considered it to lay down a rule of law that the depreciation deduction for the year in which an asset is sold must be adjusted to limit the deduction to the amount, if any, by which the adjusted basis at the start of the year exceeds the sales price. Compare *Motorlease Corp.* v. *Comm.,* 215 F. Supp. 356, 361-64 (D. C. Conn. 1963) (rev'd on appeal, July   , 1964) and Note, 41 Ore. L. Rev. 159, 165-66 (1962) with *Randolph D. Rouse,* 39 T. C. 70 (1962); Rev. Rul. 62-92, 1962-1 C. B. 29; and Note, 37 Tex. L. Rev. 787 (1959).

Though it could have been more explicit, we think that the *Cohn* case adequately supports the Commissioner's position and supports affirmance of the Tax Court's decision in this case. Section 167(a) of the Internal Revenue Code states as a general rule: "There shall be allowed as a depreciation deduction a reasonable allowance for the exhaustion, wear and tear (including a reasonable allowance for obsolescence) . . . of property used in the trade or business . . ." Thus the dispute centers about whether it is reasonable to allow a deduction for depreciation in the year in which an asset is sold for more than its adjusted basis. We think such an allowance unreasonable, for it contravenes the basic purpose of the depreciation deduction.

Basically, our income tax is a tax on net income, and the expenses of generating income are normally considered deductible from gross income. The purpose of the depreciation allowance is to enable the taxpayer to recover the net cost of a wasting asset used in his trade or business by charging the diminution in the asset's value each year against the gross income of that year. Because our income tax system is based on annual reporting and liability and the taxpayer normally holds wasting assets for more than a year, the proper amount of depreciation to be taken each year must depend on estimates. The proper depreciation allowance "is that amount which should be set aside for the taxable year in accordance with a reasonably consistent plan (not necessarily at a uniform rate), so that the aggregate of the amounts set aside, plus the salvage value, will, at the end of the estimated useful life of the property, equal the cost . . . of the property . . ." Treasury Regulations, § 1.167(a)-1. See also *United States* v. *Ludey,* 274 U. S. 295, 300-301 (1927).

The Commissioner does not claim that the depreciation schedule adopted by the taxpayer in 1955 when the *Feuer* was purchased was unreasonable. Rather his claim is that it is unreasonable to follow an estimate when one knows that estimate is incorrect. The Commissioner's position finds support in § 1.167(b)-0 (a) of the Regulations in force during 1957:

> "Any reasonable and consistently applied method of computing depreciation may be used or continued in use under section 167. Regardless of the method used in computing depreciation, deductions for depreciation shall not exceed such amounts as may be necessary to recover the unrecovered cost or other basis less salvage during the remaining useful life of the property. The reasonableness of any claim for depreciation shall be determined upon the basis of conditions known to exist at the end of the period for which the return is made."

We think the Regulations make it plain that the relevant time for assessing the reasonableness of the depreciation deduction is the end of the period for which the return is made. At the end of 1957 it hardly seems reasonable to claim that the value of the *Feuer* had declined below its adjusted basis.

To be sure, the Regulations also provide that the depreciation allowance "shall not reflect amounts representing a mere reduction in market value." § 1.167(a)-1. If depreciation schedules had to be revised each time an asset's market value rose or declined, an intolerable strain would be placed on accounting methods. But no such practical difficulty presents itself here. All that is required

is a comparison of the asset's selling price with its adjusted basis. A sale which indicates that an estimated decline in an asset's value is greatly out of line is not a "mere fluctuation in market value," but "a single and final adjustment in the closing of the books on the asset involved." *Cohn* v. *United States, supra,* 259 F. 2d at 378.

Though the increment in the *Feuer's* value resulted from a fortuity normally associated with capital gain, the depreciation allowance is measured by the net cost of the asset to the taxpayer. If an asset costs a taxpayer nothing for a year, the economic factors responsible for the lack of expense to the taxpayer should be of no concern in arriving at the depreciation allowance. Here the sale established with mathematical certainty that the entire cost of the ship had been recovered by the sale. No injustice results from denying the taxpayer an allowance he knows to be fictional at the time he claims it.

Little support for the taxpayer's position can be derived from Congressional passage in 1962 of § 1245 of the Internal Revenue Code. Section 1245 is addressed to a much broader problem than disallowance of depreciation deductions for the year of an asset's sale. The *Cohn* case refused to permit the Commissioner to recapture depreciation in years other than that of an asset's sale. Section 1245 permits recapture of depreciation allowed in years prior to an asset's sale by treating gain on the transfer of certain specified property to the extent of depreciation taken after 1961 as ordinary income instead of capital gains. See generally, Schapiro, *Recapture of Depreciation and Section 1245 of the Internal Revenue Code,* 72 Yale L. J. 1483 (1963).

The judgment of the Tax Court is affirmed.

MOORE, *Circuit Judge* (dissenting):

By its decision in this case and in *United States* v. *The Motorlease Corporation,* decided this day, this court not only enacts judicial legislation which the Congress itself has rejected but overturns judicial and administrative precedents of many years' standing in the field of allowable depreciation.

The law in effect in 1957, the applicable year here, provided as to "DEPRECIATION" that "There shall be allowed as a depreciation deduction a reasonable allowance for the exhaustion, wear and tear (including a reasonable allowance for obsolescence)—(1) of property used in a trade or business, or (2) of property held for the production of income. "(Sec. 167, Int. Rev. Code of 1954.) The basis, "for the purpose of determining the gain on the sale or other disposition of such property," was to be the "adjusted basis provided in section 1011." Sec. 167(f).

The Regulations provide for the setting aside as a depreciation deduction an amount "in accordance with a reasonably consistent plan," "so that the aggregate of the amounts set aside, plus the salvage value, will at the end of the estimated useful life of the depreciable property, equal the cost or other basis of the property as provided in section 167(f) and § 1.167(f)-1."

"Useful life," here determined by the Commissioner to have been three years, was subject to modification "by reason of conditions known to exist at the end of the taxable year" and could be "redetermined" but "only when the change in the useful life is significant." § 1.167(b).

The other important factor, "salvage value," is defined with clarity as "the amount (determined at the time of acquisition) which is estimated will be realized upon sale

or other disposition—" § 1.167(c)-1. The Regulation contains the injunctions that "Salvage value shall not be changed at any time after the determination made at the time of acquisition merely because of changes in price levels," and that "Salvage value must be taken into account in determining the depreciation deduction . . ." The time period during which depreciation is allowable is from the time "when the asset is placed in service" until it "is retired from service." Proportionate parts of one year's depreciation are allowable for the first and last years during which the asset is in service. § 1.167(g)-10.

These underlying and controlling legal principles are clear. Their application to the facts of this case are (or should be) equally clear.

The asset or property is the S.S. Feuer. Its acquisition date was December 21, 1955—the price $469,000.

The Commissioner accepted "Useful life" as three years and salvage value as $54,000. The "reasonably consistent plan" required the setting aside of $378.65 a day for depreciation. If this were done, the "aggregate of the amounts set aside" ($415,000) "plus the salvage value" ($54,000) would equal the cost ($469,000).

During 1957 the S.S. Feuer earned some $289,340 as gross profit. To achieve this profit the Feuer had to be used and after each day of its use it had suffered wear and tear (depreciation) to the extent of $378.65. The $289,340 was not the net income on which the petitioner under the law was required to pay taxes. Its obligation rested upon net income and net income was obtained only after depreciation ($135,367.24) was deducted. Thus far there can be no variance in thought or legal result—even by the Commissioner, the Tax Court or the majority.

But just as our much vaunted system of law on a national basis can be so easily ignored and repudiated both by judical and extra-judicial fiats, even more so is this true on an international basis. International law and contract to the contrary, the Suez Canal was closed to shipping in the latter part of 1956. Suddenly the price of ships soared, petitioner chose to forego the balance (approximately one and a half years—or one-half of the agreed-upon useful life) of the contemplated three-year reasonable plan period and sold the Feuer in June 1957 for $700,000 (actually $695,500 on closing).

The tax computation should have been simple. The cost ($469,000) less depreciation to the date of sale ($277,-739.51) enabled petitioner because of its sale for $695,500 to obtain a capital gain of $504,239.51, which petitioner reported.

Particularly important is it to note that although the Suez crisis had radically affected the shipping situation and ship values, the Commissioner did not avail himself of the remedy of modification of useful life and after such redetermination then, but only then, of a redetermination of salvage value. Actually his own regulation prevented him from changing salvage value "merely because of changes in price levels."

Faced with this insurmountable barrier of Congressional enactment, precedent, and regulation, the Commissioner resolved the problem by the simple and much-used device of amending the statutes without the aid or even participation of Congress. To the depreciation allowance section he merely added in substance the words "except in the event that the asset shall be sold prior to the expiration of its useful life, in which event no depreciation shall be

allowed for the year in which such sale is made if the price realized exceeds the depreciated cost at the beginning of such taxable year."

There would have been nothing wrong with such a statute; in fact, the Treasury had been trying to have similar provisions enacted for years. If, however, under our three branches of government system, the legislative branch does not function to the satisfaction of the executive and judicial branches, it is apparently incumbent on the latter two to take over the legislative powers. To be sure the taxpayer had planned his business transaction relying on the law as it was on the books at the time but sooner or later taxpayers must learn not to rely upon Commissioner's rulings, acquiescences, prior audits—or even Commissioners and courts.

What possible rationale is available for the result reached by the majority? They first infer that the Commissioner is being quite magnanimous in being "content" with only a 1957 disallowance as if taxes and the law were to depend on Commissioners' whims, caprices and contentment. They recognize that in so doing that the Commissioner was "perhaps logically inconsistent" as indeed he was. In enacting his own *ex post facto* legislation, he might just as well have had a sale for more than cost eliminate all depreciation for three years or even from the date of acquisition.

To arrive at its result the majority relies exclusively on what it can only call a strong suggestion in *Cohn* v. *United States*, 259 F. 2d 371 (6th Cir. 1958). It ignores (as it must) the many Supreme Court decisions and the statutes and regulations leading to a contrary result. When the *Cohn* case is read, no principle is found therein

which could support the Commissioner's ruling. The taxpayers in *Cohn* had not fixed any salvage value for their property at the end of its useful life. For this value the District Court chose the sale price. There was no holding in *Cohn* that sale price during the course of useful life (here at the half-way point) should eliminate all depreciation in the year of sale. Nor can *Cohn* possibly be stretched to stand for the proposition that any "reasonably consistent plan" adopted by a taxpayer is to be considered as abrogated by a sale. Any such conclusion would be in specific disregard of the statutes and regulations which provide for the methods of redetermination of useful life and salvage value.

In *Randolph D. Rouse,* 39 T.C. 70 (1962) (the Tax Court here held it "necessary to recognize the *Rouse* case as dispositive of the question presented in this case") relied upon *Cohn.* Depreciation was disallowed only as to the houses which Rouse had sold. Since he had not adopted any "reasonably consistent plan" or estimated any salvage value at the time of acquisition a situation somewhat similar to that in *Cohn* existed. Neither set of facts leads to a result which should be controlling or even persuasive here.

The Tax Court assumed, erroneously and without any supporting basis in my opinion, that "changes in economic conditions have brought about new considerations by the courts of the old, well-established rules relating to depreciation allowances in the light of the rising market prices of used assets and the corresponding realization of large gains upon the resale of such used assets." *Massey Motors, Inc.* v. *United States,* 364 U.S. 92 (1960) and *Hertz Corp.* v. *United States,* 364 U.S. 122 (1960) are

cited as examples for this proposition. Actually neither case justifies any such conclusion. Both cases involved taxpayers whose business experience enabled them to determine an estimated salvage value based upon sales long before the end of the physical life of the automobiles used in their businesses. Instead of declaring the principle that sale automatically disqualified a taxpayer from claiming depreciation if the sale price was higher than the depreciated value at the beginning of the year, the *Massey* case, as to one of the taxpayers, used the estimated salvage value of $1,325 per car instead of the actual sales price of $1,380. Had the Supreme Court wished to declare the principle now urged by the Commissioner, it had every opportunity to do so merely by taking the actual sales price. However, it did not.

A thorough and well reasoned analysis of the depreciation problem is set forth in the trial court's decision in *The Motorlease Corporation* v. *United States of America,* 215 F. Supp. 356 (D. Conn. 1963). Although a panel of this court "On the authority of, and for the reasons given in *Fribourg Navigation Co.* v. *Commissioner,* 2d Cir., Docket No. 28165, decided today," reversed *Motorlease,* this case in reality supplies neither reasons nor authority. *Motorlease* reaches its result by saying "neither the Code nor the regulations are dispositive of the issue." To ignore the tax law as clearly written and the interpreting regulations is quite essential to a decision in contravention of such laws. This court in *Motorlease* does not believe that the transmutation of ordinary income into capital gains should be encouraged. Here is another example of the judicial enactment of a law which Congress itself over a long period of years had rejected. As pointed out in *Evans* v. *Commissioner,* 264 F. 2d 502, 513 (9th Cir. 1959),

rev'd on another ground sub nom. Massey Motors, Inc. v. *United States,* 364 U. S. 92 (1960), "The legislative history of section 117(j) shows that Congress had not receded from its original purpose. Congress was aware of the Commissioner's contention that taxpayers were converting into capital gains ordinary income arising from unreasonable deductions for depreciation." After reviewing various legislative attempts to have gain treated uniformly as ordinary income the court added tersely, "The recommendation was heard but not adopted." 264 F. 2d at 514.

In *Motorlease* the Commissioner did what he did not do in *Massey.* He took sale price as a new and substituted salvage value despite the specific requirement that it was to be "determined at the time of acquisition." Thus *Motorlease* as decided by this court in substance and actuality goes contrary to the decisions of the Supreme Court in *Massey* and *Evans.*

The factual distinction which makes *Fribourg,* even as the majority decide it, completely inapplicable to *Motorlease,* is that *Fribourg* admittedly does not deal with a business which consisted of short time use of property and its sale before the expiration of its physical life. *Motorlease* was analogous to, and should have been controlled by, *Massey, Evans* and *Hertz.* Yet there is no consideration of, or even mention of, those important cases or the legal principles declared therein.

Another series of illuminating beacons the light of which is more than adequate to reveal the right path are recent district court cases from other circuits.

In *Wyoming Builders, Inc.* v. *United States,* decided March 25, 1964, U. S. D. C. D. Wyo., the court was confronted with a refund case involving the disallowance of

depreciation on property sold two months before the close of the taxpayer's fiscal year (November 1, 1957—October 31, 1958). The property, an Air Force base housing project, had been set up on a seventy-five year lease basis, all improvements to remain the property of the government upon expiration or termination. When the property was sold to the government in 1958, the taxpayer, as here, reported as a capital gain the difference between the sale price and the cost less eight years' depreciation. The court considered the applicable statutes and regulations as well as the *Cohn* case and concluded that the government's theory that no depreciation occurred in the year of sale was untenable, saying in part:

> "Depreciation occurs by use; the use of the property by the taxpayer until September 1, 1958, when the sale took place, resulted in a continued depreciation of the property until September 1, 1958. The expense of using the property was properly allocated by the taxpayer to the period of time which was benefited by that asset, that is, from the beginning of the fiscal year in issue until the date of the sale. Depreciation is the measure of the cost of that part of the assets which has been used up or gradually 'sold' through wear and tear." *United States* v. *Ludey,* 274 U. S. 295, 301 (1927).

The conclusions of the court in *Wyoming Builders* are so consonant with the law that it is impossible to conjure up countervailing arguments. The court held that "Neither the law nor the regulations permit this court to substitute the term 'sale price' for the regulation's term 'reasonable salvage value,'" and that "to sustain the disallowance of taxpayer's depreciation deduction would require an un-

warranted judicial extension of the Code and Treasury Regulations." The court believed, as do I, that, if the law is to be changed, "Congress, not the Court, must enact adequate controls and set the standards."

The history of the *Wier Long Leaf Lumber Co.* case, 9 T. C. 990 (1947) and the Commissioner's acquiescence (1948-1962), his non-acquiescence (1962) and its affirmance and partial reversal on other issues, 173 F. 2d 549 (5th Cir. 1949), is relevant here. The Tax Court held that the sale of depreciated automobiles did not preclude any depreciation allowance in the year of sale and that "mere appreciation in value due to extraneous causes [here the Suez situation] has no influence on the depreciation allowance, one way or the other."

Kimball Gas Products Co. v. *United States,* 63-2 U. S. T. C. ¶ 9507, W. D. Tex. 1962 was brought for a refund for overpayment of taxes due to the Commissioner's disallowance of depreciation in the year of sale (1959) of properties acquired in 1955 which for depreciation purposes had useful lives of seven years. The Commissioner disallowed one-half of the depreciation claimed in the year of sale. The court held that the taxpayer was entitled to the full depreciation and a tax refund.

The taxpayer in *S & A Company* v. *United States,* 218 F. Supp. 677 (D. Minn., 1963), a company manufacturing and selling outboard motors, sold its land and depreciable assets on April 1, 1956 to a company which continued the business. It claimed deduction for depreciation from September 1, 1955 to April 1, 1956 in its 1955-1956 fiscal year. The issue framed there was identical with the issue here. The court reviewed in detail the history of the tax laws material to the subject, the Regulations, the *Massey, Hertz, Cohn* and *Wier Long Leaf Lumber* cases and came

to the conclusion that the Commissioner improperly disallowed the deduction. In the course of its opinion the court pointed out the distinguishing features of the *Cohn* case (assuming it to be correct), namely, that although "a sale of an asset at the end of its useful life for an amount in excess of its undepreciated cost at the beginning of the year will justify a redetermination of salvage value," it is equally clear that the Tax Court held that sale of assets prior to the end of "useful life" at a price in excess of undepreciated cost at the beginning of the year of sale does not justify a determination of salvage value because the excess of price over cost is mere appreciation in value.

Refutation cannot be found in saying that these are only district court decisions. They are decisions which apply the tax statutes as they were written and the Supreme Court cases for the principles expounded therein. They do not attempt to ascribe to Congress an intent not enacted into law. Rather the legislative history has disclosed that Congress had been aware of the problem and had intentionally chosen not to act.

The fallibility of the majority opinion is that it completely ignores that law. The majority say "Because our income tax system is based on annual reporting . . . the proper amount of depreciation to be taken each year must depend on estimates." They should have taken notice of the statutory words requiring that salvage value be "determined at the time of acquisition"—of necessity, an estimate. They then interpret the Commissioner's claim to be that it is "unreasonable to follow an estimate when one knows that estimate is incorrect." To impute such a claim to the Commissioner is to imply that he is unable to read, understand and follow the specific provisions of the law

under which he can always seek to rectify an incorrect estimate. Instead of pursuing such a remedy here, the Commissioner concedes the accuracy both of useful life and the salvage value "determined at the time of acquisition."

Finding no support in law for its position and forced to concede that "the increment in the *Feuer's* value resulted from a fortuity normally associated with capital gain," the majority satisfy themselves with the belief that "no injustice results from denying the taxpayer an allowance he knows to be fictional at the time he claims it." Any such legal philosophy has the effect of writing depreciation allowances and depreciation as a matter of sound accounting out of the tax laws. Possibly they intend by their opinion to do so because under such circumstances they say "the economic factors responsible for the lack of expense to the taxpayer should be of no concern in arriving at the depreciation allowance." This approach can scarcely be reconciled with their comment that, "If depreciation schedules had to be revised each time an asset's market value rose or declined, an intolerable strain would be placed on accounting methods." It was for this very reason that the Regulation, § 1.167(c), provided that "Salvage value shall not be changed at any time after the determination made at the time of acquisition merely because of changes in price levels." Of course, sales price can easily be compared with the depreciated cost at the beginning of the year. But there is no law or regulation which declares that in such event no depreciation shall be allowed if the sales price is higher. Therefore, because this decision seems to be completely at variance with the statutes and the applicable decisions, I must dissent.

Judgment of the Court of Appeals

UNITED STATES COURT OF APPEALS

SECOND CIRCUIT

At a Stated Term of the United States Court of Appeals, in and for the Second Circuit, held at the United States Courthouse in the City of New York, on the fifteenth day of July, one thousand nine hundred and sixty-four.

Present:

HON. THOMAS W. SWAN,
HON. LEONARD P. MOORE,
HON. J. JOSEPH SMITH, *Circuit Judges*

FRIBOURG NAVIGATION COMPANY, INC.,
Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

Appeals from The Tax Court of the United States.

This cause came on to be heard on the transcript of record from The Tax Court of the United States, and was argued by counsel.

ON CONSIDERATION WHEREOF, it is now hereby ordered, adjudged, and decreed that the order of said The Tax Court of the United States be and it hereby is affirmed.

A. DANIEL FUSARO
Clerk

Order of the Court of Appeals Denying Petition for Rehearing

UNITED STATES COURT OF APPEALS
SECOND CIRCUIT

At a Stated Term of the United States Court of Appeals, in and for the Second Circuit, held at the United States Court House, in the City of New York, on the twentieth day of August, one thousand nine hundred and sixty-four.

Present:

HON. THOMAS W. SWAN,
HON. LEONARD P. MOORE,
HON. J. JOSEPH SMITH, *Circuit Judges.*

FRIBOURG NAVIGATION COMPANY, INC.,
Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

A petition for a rehearing together with a motion for for a stay of the issuance of mandate pending application for a writ of certiorari to the Supreme Court of the United States having been filed herein by counsel for petitioner,

Upon consideration thereof, it is

Ordered that said petition for a rehearing be and hereby is denied.

Further ordered that the motion to stay issuance of the mandate be and it hereby is granted subject to the provisions of Rule 28(c) of the rules of this court.

A. DANIEL FUSARO
Clerk

APPENDIX B

Treasury Regulations*

§ 1.167(a)-1 Depreciation In General.—(a) *Reasonable allowance.*— Section 167(a) provides that a reasonable allowance for the exhaustion, wear and tear, and obsolescence of property used in the trade or business or of property held by the taxpayer for the production of income shall be allowed as a depreciation deduction. The allowance is that amount which should be set aside for the taxable year in accordance with a reasonably consistent plan (not necessarily at a uniform rate), so that the aggregate of the amounts set aside, plus the salvage value will, at the end of the estimated useful life of the depreciable property, equal the cost or other basis of the property as provided in section 167(f) and § 1.167(f)-1. An asset shall not be depreciated below a reasonable salvage value under any method of computing depreciation. See paragraph (c) below for definition of salvage. The allowance shall not reflect amounts representing a mere reduction in market value.

(b) *Useful life.*—For the purpose of section 167 the estimated useful life of an asset is not necessarily the useful life inherent in the asset but is the period over which the asset may reasonably be expected to be useful to the taxpayer in his trade or business or in the production of his income. This period shall be determined by reference to his experience with similar property taking into account present conditions and probable future developments. Some of the factors to be considered in determining this period are (1) wear and tear and decay or decline from natural causes, (2) the normal progress of the art, economic

*As in effect during the calendar year 1957.

changes, inventions, and current developments within the industry and the taxpayer's trade or business, (3) the climatic and other local conditions peculiar to the taxpayer's trade or business, and (4) the taxpayer's policy as to repairs, renewals, and replacements. Salvage value is not a factor for the purpose of determining useful life. If the taxpayer's experience is inadequate, the general experience in the industry may be used until such time as the taxpayer's own experience forms an adequate basis for making the determination. The estimated remaining useful life may be subject to modification by reason of conditions known to exist at the end of the taxable year and shall be redetermined when necessary regardless of the method of computing depreciation. However, estimated remaining useful life shall be redetermined only when the change in the useful life is significant and there is a clear and convincing basis for the redetermination. For rules covering agreements with respect to useful life, see section 167(d) and § 1.167(d)-1.

(c) *Salvage.*—Salvage value is the amount (determined at the time of acquisition) which is estimated will be realizable upon sale or other disposition of an asset when it is no longer useful in the taxpayer's trade or business or in the production of his income and is to be retired from service by the taxpayer. Salvage value shall not be changed at any time after the determination made at the time of acquisition merely because of changes in price levels. However, if there is a redetermination of useful life under the rules of paragraph (b), salvage value may be redetermined based upon facts known at the time of such redetermination of useful life. Salvage, when reduced by the cost of removal, is referred to as net salvage. The time at which

an asset is retired from service may vary according to the policy of the taxpayer. If the taxpayer's policy is to dispose of assets which are still in good operating condition, the salvage value may represent a relatively large proportion of the original basis of the asset. However, if the taxpayer customarily uses an asset until its inherent useful life has been substantially exhausted, salvage value may represent no more than junk value. Salvage value must be taken into account in determining the depreciation deduction either by a reduction of the amount subject to depreciation or by a reduction in the rate of depreciation, but in no event shall an asset (or an account) be depreciated below a reasonable salvage value. See, however, § 1.167(b)-2(a) for the treatment of salvage under the declining balance method. The taxpayer may use either salvage or net salvage in determining depreciation allowances but such practice must be consistently followed and the treatment of the costs of removal must be consistent with the practice adopted. For specific treatment of salvage value see §§ 1.167(b)-1, 2, and 3. When an asset is retired or disposed of, appropriate adjustments shall be made in the asset and depreciation reserve accounts. For example, the amount of the salvage adjusted for the costs of removal may be credited to the depreciation reserve. [T. D. 6182, 6-11-56. Later amended by T. D. 6507, 12-1-60 and by T. D. 6712, 3-23-64.]

§ 1.167(a)-9 Obsolescence.—The depreciation allowance includes an allowance for normal obsolescence which should be taken into account to the extent that the expected useful life of property will be shortened by reason thereof. Obsolescence may render an asset economically useless to the taxpayer regardless of its physical condition. Obsolescence

is attributable to many causes, including technological improvements and reasonably foreseeable economic changes. Among these causes are normal progress of the arts and sciences, supercession or inadequacy brought about by developments in the industry, products, methods, markets, sources of supply, and other like changes, and legislative or regulatory action. In any case in which the taxpayer shows that the estimated useful life previously used should be shortened by reason of obsolescence greater than had been assumed in computing such estimated useful life, a change to a new and shorter estimated useful life computed in accordance with such showing will be permitted. No such change will be permitted merely because in the unsupported opinion of the taxpayer the property may become obsolete. For rules governing the allowance of a loss when the usefulness of an asset is suddenly terminated, see section 165 and the regulations thereunder. If the estimated useful life and the depreciation rates have been the subject of a previous agreement, see section 167(d) and § 1.167(d)-1. [T. D. 6182, 6-11-56. Later amended by T. D. 6445, 1-15-60.]

§ 1.167(a)-10 When Depreciation Deduction Is Allowable.—(a) A taxpayer should deduct the proper depreciation allowance each year and may not increase his depreciation allowances in later years by reason of his failure to deduct any depreciation allowance or of his action in deducting an allowance plainly inadequate under the known facts in prior years. The inadequacy of the depreciation allowance for property in prior years shall be determined on the basis of the allowable method of depreciation used by the taxpayer for such property or under the straight line method if no allowance has ever been

claimed for such property. The preceding sentence shall not be construed as precluding application of any method provided in section 167(b) if taxpayer's failure to claim any allowance for depreciation was due solely to erroneously treating as a deductible expense an item properly chargeable to capital account. For rules relating to adjustments to basis, see section 1016 and the regulations thereunder.

(b) The period for depreciation of an asset shall begin when the asset is placed in service and shall end when the asset is retired from service. A proportionate part of one year's depreciation is allowable for that part of the first and last year during which the asset was in service. . . . [T. D. 6182, 6-11-56.]

FILED
DEC 8 1964
JOHN F. DAVIS, CLERK

IN THE

Supreme Court of the United States

OCTOBER TERM, 1964

No. [redacted] 23

FRIBOURG NAVIGATION COMPANY, INC.,
Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

SUPPLEMENTAL MEMORANDUM IN SUPPORT OF PETITION FOR A WRIT OF CERTIORARI

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December 7, 1964.

IN THE

Supreme Court of the United States

OCTOBER TERM, 1964

FRIBOURG NAVIGATION COMPANY, INC., *Petitioner,* *v.* COMMISSIONER OF INTERNAL REVENUE, *Respondent.*	No. 679

SUPPLEMENTAL MEMORANDUM IN SUPPORT OF PETITION FOR A WRIT OF CERTIORARI

On November 27, 1964—two weeks after we filed our petition for a writ of certiorari—the Court of Appeals for the Eighth Circuit squarely disapproved the decision below. *United States* v. *S & A Company*, F. 2d (8th Cir. 1964), reprinted in the Appendix, *infra*, pp. 1a-32a. In this decision the Eighth Circuit affirmed a District Court decision (discussed at pages 7-8 and 14 of our petition) which conflicts directly with the Second Circuit's decision in our case. The explicit conflict between the Second and Eighth Circuits is a new reason for granting the petition.

In *United States* v. *S & A Company*, *supra*, the taxpayer made an "unanticipated and non-customary good-faith sale" of depreciable assets. The "sale price was greater than the assets' adjusted basis at the beginning of the tax year." "The question," said the Eighth Circuit, "is whether, on these facts, the taxpayer is entitled to any deduction for depreciation on the sale assets in the sale year." Appendix, *infra*, p. 1a.

The Eighth Circuit noted that "the point is one strenuously in contest at the present time. The cases recently decided do not appear to be uniform."[1] "The Second Circuit," it added, "has upheld the disallowance of the deduction [citing the opinion below and *United States* v. *Motorlease Corporation*, 334 F. 2d 617 (2d Cir. 1964)]." Appendix, *infra*, p. 2a.

While expressing "deep respect for the conclusions reached by the Second Circuit majorities in *Fribourg* and *Motorlease*," the Eighth Circuit reached the opposite conclusion. The Eighth Circuit stated that "the results in those cases underestimate . . . the law's dichotomy of approach to depreciation and to capital gain" and fail to distinguish "between an intended sale of depreciable assets at or near the end of useful life and an unanticipated sale in midlife." The Eighth Circuit, finding this dichotomy and distinction "to be important and significant," held that the "taxpayer's claimed deduction for depreciation on the sale assets . . . was a proper deduction under § 167 of the 1954 Code."[2] Appendix, *infra*, pp. 29a-30a.

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[1]Since our petition for certiorari was written five additional decisions allowing depreciation in the year of profitable sale and disagreeing with the decision below have been announced: *Harry Trotz*, 43 T.C. No. 13 (Nov. 6, 1964); *C. L. Nichols*, 43 T.C. No. 14 (Nov. 6, 1964); *Moses Lake Homes, Inc.* T.C. Memo. 1964-289 (Nov. 5, 1964); *Holder Driv-Ur-Self, Inc.*, 43 T.C. No. 19 (Nov. 20, 1964); *Occidental Loan Co.* v. *United States*, 64-2 U.S.T.C. ¶ 9847 (S.D. Calif., Nov. 13, 1964). See also *Melvon C. Miller*, T.C. Memo. 1964-305 (Nov. 20, 1964), which sustained disallowance of such depreciation, not as a matter of law, but for failure of proof that the claimed depreciation deductions were accurate.

[2]Judge Van Oosterhout, dissenting, said he was "in accord with the interpretation made of the depreciation statute and regulations by the separate panels of the Second Circuit in *Fribourg Nav. Co* v. *Commissioner*, 2 Cir., 335 F. 2d 15, and *United States* v. *Motorlease Corp.*, 2 Cir., 334 F. 2d 617" and that he "would reverse upon the basis of the majority opinions in such cases." Appendix, *infra*, p. 32a.

S & A Company and the instant case could not be more explicitly parallel. In both cases, assets were unexpectedly sold in the middle of useful life. Neither taxpayer had followed a practice of selling similar assets after limited use. Both taxpayers had depreciated the assets under admittedly reasonable—and approved—estimates of useful life and salvage value. In both cases the gains on sale were due to market factors. The inescapable inference in both cases was that the claimed depreciation would have been allowed if the assets had not been sold. Both cases present, on undisputed facts, the same pure question of law: Does the unanticipated profitable sale of a depreciable asset in the middle of its useful life necessarily bar deduction of depreciation on the asset for the year of sale?

Grant of certiorari is necessary to resolve the square conflict between the Second and Eighth Circuits on this important and widely litigated question.

Respectfully submitted,

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December 7, 1964.

United States Court of Appeals
FOR THE EIGHTH CIRCUIT

No. 17,555

United States of America, Appellant, v. S & A Company, Appellee.	Appeal from the United States District Court for the District of Minnesota.

[November 27, 1964.]

Before Van Oosterhout, Blackmun and Mehaffy, Circuit Judges.

Blackmun, Circuit Judge.

This tax controversy centers on the unanticipated and non-customary good-faith sale, during the taxpayer's fiscal year 1956, of all operating assets used in its business of manufacturing and marketing outboard motors. The sale price was greater than the assets' adjusted basis at the beginning of the tax year and, indeed, was even greater than original cost. The question is whether, on these facts, the taxpayer is entitled to any deduction for depreciation on the sale assets in the sale year. Chief Judge Devitt found that the deduction claimed was a "reasonable

allowance", within the meaning of § 167(a) of the Internal Revenue Code of 1954, unless the sale "in and of itself creates a reason for changing the depreciation allowance". He concluded that it did not.[1] 218 F.Supp. 677 (D. Minn. 1963). Judgment for the taxpayer in the amount of $72,590.76 was entered.

From a practical point of view, the issue is whether, on the one hand, depreciation in a favorable sale year may serve to offset ordinary income, with, as a result, greater capital gain on the sale, or, on the other hand, may not be so offset, with resulting greater ordinary income and less capital gain.[2]

Here, once again, see *General Bancshares Corp.* v. *Commissioner,* 326 F.2d 712, 713 (8 Cir. 1964), cert. denied, ... U.S. ..., it may offhand seem surprising that this question arises only now, after the modern federal income tax and depreciation as a specified deduction have been with us continuously for over fifty years. Revenue Act of 1913, § II B and G(b). Nevertheless, the point is one strenuously in contest at the present time. The cases recently decided do not appear to be uniform. The Second Circuit, in opinions simultaneously filed by two separate panels on July 15, 1964, with a different judge vigorously dissenting in each case, has upheld the disallowance of the deduction. *Fribourg Nav. Co.* v. *Commissioner,* ... F.2d ... (2 Cir. 1964); *United States* v. *Motorlease Corp.,* ...

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1 It has been said, as to this holding, "The court's rejection of the Commissioner's position is supported by both authority and reason." 48 Minn. L. Rev. 628, 632-33 (1964).

2 With the addition, by the Revenue Act of 1962, Pub. L. 87-834, § 13 (a) (1), 76 Stat. 1032, of what is now § 1245 of the 1954 Code, applicable to taxable years beginning after 1962, the issue no longer exists for the type of property here involved. By this specific statute, capital gain treatment is not now available. The statute, however, does not purport to affect directly the depreciation provisions of the Code. See, also, § 1250 of the 1954 Code, added by the Revenue Act of 1964, Pub. L. 88-272, § 231(a), 78 Stat. 100, and applicable to taxable years ending after 1963.

F.2d ... (2 Cir. 1964). To the same effect is *Killebrew* v. *United States*, 64-2 USTC, par. 9728 (E.D. Tenn. 1964). On the other hand, three district courts, in addition to Judge Devitt here, have approved deductibility and rendered decisions in favor of the taxpayer. *Wyoming Builders, Inc.* v. *United States*, 227 F.Supp. 534 (D. Wyo. 1964), on appeal to the Tenth Circuit; *Kimball Gas Products Co.* v. *United States*, 63-2 USTC, par. 9507 (W.D. Tex. 1962), on appeal to the Fifth Circuit; and *Motorlease Corp.* v. *United States*, 215 F.Supp. 356 (D. Conn. 1963), which the Second Circuit reversed by its split decision.

In addition, the Tax Court, on September 29, 1964, in a decision reviewed by the entire court (with one judge concurring separately and five judges dissenting), although reciting agreement with the results on the facts of *Fribourg* and *Motorlease*, has disagreed "with the rationale" of those decisions and has upheld depreciation in the year of sale. *Macabe Co.*, 42 T.C. No. 87. And in still another case, decided October 20, 1964, and reviewed by the entire court (with three judges concurring separately and one judge dissenting), the Tax Court disallowed acquisition-year depreciation where the sale was negotiated during the acquisition year and closed at the very beginning of the succeeding year. *Smith Leasing Co.*, 43 T.C. No. 5.

We are confronted, therefore, with varying approaches to the problem.

The facts here. These are established by the pleadings and stipulations. The taxpayer, S & A Company, uses the fiscal year ended August 31 and the accrual method of accounting. On April 1, 1956, the taxpayer sold all its outboard motor operating assets to McCulloch Corporation for cash, notes, and the assumption of liabilities. McCul-

loch acquired the assets it so purchased "for the purpose of continuing to carry on the business of manufacturing and selling outboard motors in the same manner as said business was carried on by" S & A and "has continued and expects to continue to carry on said business at the same location with substantially the same employees".

Taxpayer timely filed its return for its fiscal year 1956. It allocated the sale price among the several assets sold and elected to report its gain on the installment basis. In the return it claimed a deduction for depreciation on the sale assets for the period from the beginning of the fiscal year to the date of the sale. The amount of the claim was consistent with the straight-line depreciation which had been asserted by the taxpayer and which had been allowed by the Commissioner of Internal Revenue with respect to the taxpayer's returns for fiscal 1955 and prior fiscal years. The Commissioner, however, disallowed the deduction for fiscal 1956.

The government by its brief concedes, and the district court found: At all times from its acquisition of the depreciable assets and until their sale, the taxpayer intended to use those assets in its business for their entire economic life. The taxpayer also estimated their period of business usefulness to be the entire economic life. This expectation "at all times prior to the effectuation of the sale" was reasonable and consistent with prior experience. At no time before the sale did the taxpayer have any plan to sell or otherwise dispose of the depreciable assets before the end of their life. This life had not terminated at the time of the sale.

Questions which are not before us. It is well to note what is not in contest here: (1) No question is raised as

to the taxpayer's allocation of the sale proceeds among the several assets sold; the propriety of this is accepted. (2) No question is raised as to the taxpayer's right to report its gain on the sale by the installment method; this is assured by § 453 of the 1954 Code. (3) No question is raised as to the taxpayer's use of the straight line method of depreciation; this is permitted by § 167(b)(1) of the Code. And (4) no question is raised as to the amount of the depreciation claimed, that is, as to its reasonableness and propriety, if any depreciation is allowable at all.

The issue, therefore, we emphasize again, is simply whether the fact that this favorable sale took place during the tax year necessitates, in the light of all the other facts here, the disallowance of otherwise allowable depreciation.

The statute and the regulations. The 1954 Code, of course, controls. Section 167(a) states simply and flatly, "There shall be allowed as a depreciation deduction a reasonable allowance for the exhaustion, wear and tear . . . of property used in the trade or business". The section goes on to provide that the "reasonable allowance" shall be computed under the straight line method, employed by the taxpayer here, or under one of other acceptable methods. Subsection (f)[3] provides that "The basis on which exhaustion, wear and tear . . . are to be allowed . . . shall be the adjusted basis provided in section 1011 for the purpose of determining the gain on the sale or other disposition of such property". This adjusted basis, by § 1012, with exceptions not significant here, "shall be the cost of such property". Thus, the statute establishes the de-

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[3] Subsection (f) of § 167 has now become subsection (g). This redesignation was effected by the Revenue Act of 1962, § 13(c)(1), Pub. L. 87-834, 76 Stat. 1034.

preciation standard of a "reasonable allowance" and it gears depreciation to cost. It does not define the terms "salvage value" or "useful life"; the latter does appear in the statute and both are used in the regulations.

The pertinent portions of the regulations under the 1954 Code are set forth in the margin.[4] It is readily apparent

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[4] § 1.167(a)-1 Depreciation in general

(a) Reasonable allowance. . . . The allowance is that amount which should be set aside for the taxable year in accordance with a reasonably consistent plan (not necessarily at a uniform rate), so that the aggregate of the amounts set aside, plus the salvage value, will, at the end of the estimated useful life of the depreciable property, equal the cost or other basis of the property . . . An asset shall not be depreciated below a reasonable salvage value . . . The allowance shall not reflect amounts representing a mere reduction in market value. . . .

(b) Useful life. For the purpose of section 167 the estimated useful life of an asset is not necessarily the useful life inherent in the asset but is the period over which the asset may reasonably be expected to be useful to the taxpayer in his trade or business or in the production of his income. . . . Salvage value is not a factor for the purpose of determining useful life. . . . The estimated remaining useful life may be subject to modification by reason of conditions known to exist at the end of the taxable year and shall be redetermined when necessary regardless of the method of computing depreciation. However, estimated remaining useful life shall be redetermined only when the change in the useful life is significant and there is a clear and convincing basis for the redetermination. . . .

(c) Salvage. Salvage value is the amount (determined at the time of acquisition) which is estimated will be realizable upon sale or other disposition of an asset when it is no longer useful in the taxpayer's trade or business or in the production of his income and is to be retired from service by the taxpayer. Salvage value shall not be changed at any time after the determination made at the time of acquisition merely because of changes in price levels. However, if there is a redetermination of useful life under the rules of paragraph (b) of this section, salvage value may be redetermined based upon facts known at the time of such redetermination of useful life. . . . The time at which an asset is retired from service may vary according to the policy of the taxpayer. If the taxpayer's policy is to dispose of assets which are still in good operating condition, the salvage value may represent a relatively large proportion of the original basis of the asset. However, if the taxpayer customarily uses an asset until its inherent useful life has been substantially exhausted, salvage value may represent no more than junk value. Salvage value must be taken into account in determining the depreciation deduction either by a reduction of the amount subject to depreciation or by a reduction in the rate of depreciation, but in no event shall an asset (or an account) be depreciated below a reasonable salvage value. . . .

§ 1.167(a)-8 Retirements

(a) Gains and losses on retirements. For the purposes of this section the term "retirement" means the permanent withdrawal of depreciable

that these, too, as is to be expected, tie depreciation to cost; that they take into account a salvage value at the end of the asset's useful life; that useful life is the reasonably expected period of the taxpayer's business use of the asset; that useful life and salvage value are both estimates and are made at acquisition; that they deny effects occasioned by market fluctuations; that they refer to the taxpayer's "policy" of asset disposal; that they speak in terms of tax years, including both the year the asset is placed in service and the year it is retired, and in terms of deductibility each year; that a depreciable asset's retirement may be effected by sale; that gain or loss may result on the sale; and that reasonableness is determined upon end-of-the-year conditions.

We particularly note that the Second Circuit majority in *Motorlease,* supra, p. ... of ... F.2d., stated that "neither the Code nor the regulations are dispositive of

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property from use in the trade or business or in the production of income. The withdrawal may be made in one of several ways. For example, the withdrawal may be made by selling or exchanging the asset, or by actual abandonment. . . .

(1) Where an asset is retired by sale at arm's length, recognition of gain or loss will be subject to the provisions of sections 1002, 1231, and other applicable provisions of law. . . .

§ 1.167(a)-10 When depreciation deduction is allowable

(a) A taxpayer should deduct the proper depreciation allowance each year. . . .

(b) The period for depreciation of an asset shall begin when the asset is placed in service and shall end when the asset is retired from service. A proportionate part of one year's depreciation is allowable for that part of the first and last year during which the asset was in service. . . .

§ 1.167(b)-(o) Methods of computing depreciation

(a) In general. Regardless of the method used in computing depreciation, deductions for depreciation shall not exceed such amounts as may be necessary to recover the unrecovered cost or other basis less salvage during the remaining useful life of the property. The reasonableness of any claim for depreciation shall be determined upon the basis of conditions known to exist at the end of the period for which the return is made. It is the responsibility of the taxpayer to establish the reasonableness of the deduction for depreciation claimed. Generally, depreciation deductions so claimed will be changed only where there is a clear and convincing basis for a change. . . .

the issue", and that the *Fribourg* and *Motorlease* dissenters took issue with that statement.

Legislative history. Until 1942 any gain on the sale of a depreciable business asset was taxed at ordinary rates. Consequently, the allowance or disallowance of depreciation in the sale year, with corresponding presence or absence of adjustment in basis, made no difference in ultimate tax. The 1942 Act extended capital gain treatment to gains realized upon the sale of certain depreciable noninventory business assets.[5] Thereafter, on a number of occasions, Congress was advised of situations deemed to present undeserving capital gain advantages and of the possible need to treat certain gains in this business asset area as ordinary income. See Hearings Before the House Committee on Ways and Means, 80th Cong., 1st Sess., on Revenue Revisions 1947-48, Part 5, p. 3756; remarks of Senator Milliken in connection with H.R. 8920, 81st Cong., 2d Sess., 96 Cong. Rec. 14057 (1950); H. Rep. No. 3124, 81st Cong., 2d Sess. 29 (1950); H. Rep. No. 586, 82d Cong., 1st Sess. 26 (1951); Hearings Before the Senate Committee on Finance, 83d Cong., 2d Sess., on H. R. 8300, Part 3, p. 1324; H. Rep. No. 1337, 83d Cong., 2d Sess. A275 (1954); remarks of Representative Curtis at 100 Cong. Rec. 3678 (1954); remarks of the President in his budget message to Congress of January 18, 1960, Budget of the United States Government for the Fiscal Year Ending June 30, 1961, p. M-11; Treasury Department Release A-761, dated February 15, 1960; letter dated April 20, 1961, of the President to Congress, Hearings Before the House Committee on Ways and Means on the President's 1961 Tax Recommendations, vol. 1, p. 13; H. Rep. No. 1447, 87th Cong.,

[5] Revenue Act of 1942, § 151(b), which added subsection (j) to § 117 of the 1939 Code. This, with later amendments, came over to the 1954 Code as § 1231.

2d Sess. 66-67 (1962); and S. Rep. No. 1881, 87th Cong., 2d Sess. 95 (1962). Congress, however, did not act on all these recommendations and, when it did, it changed only the classification from capital gain to ordinary income. It did not change the depreciation section. See, for example, Revenue Act of 1950, § 216(c), adding subsection (g)(3) to § 117 of the 1939 Code, now § 1238 of the 1954 Code; Revenue Act of 1951, § 328(a), adding subsection (o) to § 117 of the 1939 Code, now § 1239 of the 1954 Code; Revenue Act of 1962, § 13(a)(1), adding § 1245 to the 1954 Code; and Revenue Act of 1964, § 231(a), adding § 1250 to the 1954 Code.

As to all this, the government says that the suggestions to Congress were directed at sale gains attributable to depreciation allowable in prior years and not to sale year depreciation.

Supreme Court cases. United States v. *Ludey,* 274 U.S. 295, 300-01 (1927), contains Mr. Justice Brandeis' characterization of depreciation[6] as the "reduction" of the asset by wear and tear throughout its useful life in the business; as constituting, in theory, "a gradual sale"; and as requiring a corresponding adjustment downward in original cost, despite the absence of a specific provision to that

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6 "The depreciation charge permitted as a deduction from the gross income in determining the taxable income of a business for any year represents the reduction, during the year, of the capital assets through wear and tear of the plant used. The amount of the allowance for depreciation is the sum which should be set aside for the taxable year, in order that, at the end of the useful life of the plant in the business, the aggregate of the sums set aside will (with the salvage value) suffice to provide an amount equal to the original cost. The theory underlying this allowance for depreciation is that by using up the plant, a gradual sale is made of it. The depreciation charged is the measure of the cost of the part which has been sold. When the plant is disposed of after years of use, the thing then sold is not the whole thing originally acquired. The amount of the depreciation must be deducted from the original cost of the whole in order to determine the cost of that disposed of in the final sale of properties. Any other construction would permit a double deduction for the loss of the same capital assets."

effect in the then controlling statute.[7] *Massey Motors, Inc.* v. *United States,* 364 U.S. 92, 93, 107 (1960), refines the *Ludey* approach with the rule that the reasonable allowance for depreciation of business property "is to be calculated over the estimated useful life of the asset while actually employed by the taxpayer, applying a depreciation base of the cost of the property to the taxpayer less its resale value at the estimated time of disposal", and that "the useful life of the asset be related to the period for which it may reasonably be expected to be employed in the taxpayer's business". *Hertz Corp.* v. *United States,* 364 U.S. 122 (1960), accompanies *Massey* and upholds the provision of the regulations that "in no event shall an asset . . . be depreciated below a reasonable salvage value". One must mention, also, *Detroit Edison Co.* v. *Commissioner,* 319 U.S. 98, 101 (1943), with its concise statement of the purpose of the depreciation deduction,[8] repeated with approval in *Massey,* p. 104 of 364 U. S., and *Virginian Hotel Corp.* v. *Helvering,* 319 U.S. 523, 525-26 (1943), with its emphasis on the continuity of wear and tear and on the year as the unit of taxation.

We emphasize at this point that the automobiles with which *Massey* was concerned were not retained by those taxpayers for their economic life and had not been acquired with the intent so to retain them for that period. Thus their "salvage value was not junk value but the resale value at the time of disposal"[9] and "the experience

7 The 1954 Code contains such a provision in its § 1016(a)(2). So have all predecessor Revenue Acts since that of 1924, with its § 202(b).

8 "The end and purpose of it all is to approximate and reflect the financial consequences to the taxpayer of the subtle effects of time and use on the value of his capital assets. For this purpose it is sound accounting practice annually to accrue as to each classification of depreciable property an amount which at the time it is retired will with its salvage value replace the original investment therein."

9 It is to be noted, however, that in *Commissioner* v. *Evans*, the companion case to *Massey*, and covered by the same opinion, the salvage value

of the taxpayers clearly indicates a utilization of the asset for a substantially shorter period than its full economic life". Pp. 95-97 of 364 U.S. It was in the context of these factual observations that the Court made its references, pp. 97 and 101, to salvage value, at the end of full economic life, as being "ordinarily nominal"; to the conversion of amounts "from income taxable at ordinary rates to that taxable at the substantially lower capital gains rates"; to the effect that "Congress intended by the depreciation allowance not to make taxpayers a profit thereby, but merely to protect them from a loss"; and that "Accuracy in accounting requires that correct tabulations, not artificial ones, be used".

Other pertinent cases. Cohn v. *United States,* 259 F.2d 371 (6 Cir. 1958), concerned depreciable assets owned by three flying schools, the programs of which had December 31, 1944, as the "target date" of reasonable maximum duration. Depreciation was computed accordingly but with no provision for salvage value. The assets of each school were sold at or about the end of useful life at prices in excess of adjusted cost at the beginning of the tax year. Depreciation for the year of sale was claimed but disallowed. The district court upheld the disallowance for the sale year and, as to one school, even for the year preceding sale. The Sixth Circuit approved what it regarded as "a reconsideration and redetermination of salvage value" and described the question before it in the following words, p. 378 of 259 F.2d:

> "In so far as this case is concerned the issue is whether salvage value can be adjusted at or near the end of the useful life of the asset when it is shown by

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as determined by the Commissioner was not identical with sale price but was, in fact, lower than sale price. Pp. 94-95 of 364 U.S.

an actual sale of the asset that there is a substantial difference between what was estimated and what it actually is. We are not concerned with mere fluctuations or with any fluctuations from year to year. On the contrary, we have a single and final adjustment in the closing of the books on the asset involved."

Wier Long Leaf Lumber Co., 9 T.C. 990 (1947), reversed in part, on another issue, 173 F.2d 549 (5 Cir. 1949), concerned depreciation on a sawmill and on three business automobiles. Here the useful life of the mill was dependent upon available standing timber. The mill was favorably sold, due to war conditions, at the time the timber was substantially exhausted. The automobiles were sold in the same year but before the end of their estimated useful life. The Tax Court, in a decision reviewed by the court, with five dissents, disallowed depreciation on the mill in the year of sale, but, with two dissents, allowed it on the automobiles. The court's theory of decision as to the mill is revealed when it refers to "the currently ascertained correct salvage value" and an "adjustment to correct for mistaken salvage value", p. 998 of 9 T.C. On the automobile issue the court observed, p. 999, that "mere appreciation in value due to extraneous causes has no influence on the depreciation allowance, one way or the other. . . . The sole fact . . . that a given price is received for articles not fully depreciated throws no light on the effect upon the depreciation allowance". The court thus drew a distinction between what it regarded, on the facts of that case, as a justifiable adjustment in salvage value on a sale at or near the end of economic life and the impropriety of such an adjustment merely because of the fact of sale in midlife. It may be of some interest and significance, so far as the Commissioner's attitude is concerned, that he acquiesced in *Wier*, 1948-1 C.B. 3, for fourteen years and

then, after the present suit was instituted, withdrew that acquiescence, 1962-1 C.B. 5.

This same distinction, as to the timing of the sale, appears to have been made in *Kimball Gas Products Co.* v. *United States*, supra, 63-2 USTC, par. 9507 (W.D. Tex. 1962), at p. 89127, now on appeal to the Fifth Circuit. Mr. Justice Harlan in his separate dissenting-concurring opinion in *Massey* observed, p. 113 of 364 U.S., that there "even the Commissioner does not contend that a taxpayer who *happens* to dispose of some asset before its physical exhaustion must depreciate it on a useful life equal to the time it was actually held". Although this statement appears in dissent, it is factual in nature and we see no reason why it is not to be accepted as true.

Wyoming Builders, Inc. v. *United States*, supra, 227 F.Supp. 534 (D. Wyo. 1964), now on appeal to the Tenth Circuit, and *Motorlease Corp.* v. *United States*, supra, 215 F.Supp. 356 (D. Conn. 1963), reversed, as above noted, by the Second Circuit, are other cases where, with opposition by the government, trial courts have allowed depreciation in the year where the asset was sold at a price greater than adjusted basis at the beginning of the year.

Then came the Second Circuit's decisions in *Fribourg* and *Motorlease*, supra. *Fribourg* concerned a ship sold, after two years of its three year "concededly reasonable" estimated life, at a price made extraordinarily favorable because, as the Court described it, the estimate of economic life and salvage value, originally specifically approved by the Commissioner, "was thrown out of kilter by a scarcity of ships resulting from the Suez Crisis of 1956-1957, which sharply inflated the values of ships normally considered obsolete". *Motorlease* concerned vehicles sold or traded in by an automobile lessor, as a general

practice, after one or two years. In *Fribourg* the majority observed that, "Though perhaps logically inconsistent", its conclusion was "strongly suggested" by *Cohn*, and that "the increment in [the ship's] value resulted from a fortuity normally associated with capital gain". *Killebrew* v. *United States*, supra, 64-2 USTC, par. 9728 (E.D. Tenn.) is a district court decision approving disallowance.

Randolph D. Rouse, 39 T.C. 70, 76-77 (1962), did not draw the distinction which, as we have noted, was made in *Cohn* and *Wier*. The taxpayer there, because of changes in real estate conditions, sold certain houses he had held for rental. His sales prices were in excess of adjusted basis as of the year's beginning. The Tax Court judge, in an opinion not reviewed by the entire court, concluded, citing *Cohn*, "Accordingly, no depreciation deduction is allowable on account of a home thus sold for the taxable year during which it was sold". In rather dramatic contrast, however, he also concluded that the Commissioner erred in disallowing claimed depreciation on similar houses not sold. Two later single judge cases followed *Rouse*, *Fribourg Nav. Co.*, 21 T.C.M. 1533 (1962), affirmed by the Second Circuit, supra, and *Contra Costa Trucking Co.*, 22 T.C.M. 1018 (1963). See also, *Edward V. Lane*, 37 T.C. 188 (1961), which, however, concerned a taxpayer who employed the completed contract method and thus was not required to make the original estimates for annual depreciation deductions.

Rouse was followed by the September 29, 1964, decision of the Tax Court in *Macabe Company, Inc.*, supra. This case concerned a downtown Portland, Oregon, office building reconstructed after acquisition by the taxpayer. It was "unexpectedly disposed of" in midlife, partly because

of the cash requirements of the estate of a deceased shareholder of the taxpayer. It was stipulated that after reconstruction of the building the value of downtown rental properties in Portland "increased substantially". The Tax Court majority concluded that the Commissioner's position failed to take into account the distinction between true depreciation, that is, the gradual exhaustion of property, on the one hand, and, on the other, a rise or fall in value because of market conditions, and, further, that the Commissioner failed to comply with the underlying intent of the statute and the provisions of his own regulations. It noted the Second Circuit's opinions in *Fribourg* and *Motorlease;* chose not to disagree with the results in those two cases on the theory that at least a portion of the gains there seemed to have resulted from "inaccurate estimates" and that there was lack of proof as to the gain's being due to market appreciation; concluded, apparently, that the opposite was true in *Macabe;* and stated that, to the extent that *Rouse,* supra, was inconsistent, "we decline to follow it". Judge Withey concurred on the ground that Congress, in allowing a deduction for depreciation, did so with the intent that it was to be offset against ordinary income and not against a capital gain resulting from a sale or exchange of the asset. *Smith Leasing Co.,* which we have noted above, came down three weeks later.

In addition, we note, for what it may be worth, that there is an imposing number of other older cases which reveal situations where depreciation has been computed and allowed during the year of a favorable sale. Among these are the Supreme Court cases of *United States* v. *Ludey,* supra, 274 U.S. 295, reversing 61 Ct. Cl. 126, and *Eldorado Coal & Mining Co.* v. *Mager,* 255 U.S. 522, 526 (1921); our own case of *Forrester Box Co.* v. *Commis-*

sioner, 123 F.2d 225 (8 Cir. 1941); apparently the Second and Third Circuit cases of *Kittredge* v. *Commissioner,* 88 F.2d 632 (2 Cir. 1937); *Beckridge Corp.* v. *Commissioner,* 129 F.2d 318 (2 Cir. 1942); and *Rieck* v. *Heiner,* 25 F.2d 453, 454 (3 Cir. 1928), cert. denied 277 U.S. 608; the Court of Claims case of *Hall* v. *United States,* 43 F.Supp. 130, 131 (Ct. Cl. 1942), cert. denied 316 U.S. 664; and a number of Board of Tax Appeals cases, *Grosvenor Atterbury,* 1 BTA 169, 171 (1924); *Even Realty Co.,* 1 BTA 355, 356 (1925); *W. W. Carter Co.,* 1 BTA 849, 850 (1925); *Star Sporting Goods Co.,* 1 BTA 1266 (1925); *Keighley Mfg. Co.,* 2 BTA 10, 11 (1925); *Marchetti Roma Cafe Co.,* 2 BTA 529, 530 (1925); *Walter Frank,* 2 BTA 905 (1925); *Cotton Concentration Co.,* 4 BTA 121, 123 (1926); *Island Line Shipping Co.,* 4 BTA 1055 (1926); *Seton Falls Realty Co.,* 6 BTA 883, 884 (1927); *Parkersburg & Marietta Sand Co.,* 11 BTA 87, 90 (1928); *Louis Kalb,* 15 BTA 865 (1929); *Max Eichenberg,* 16 BTA 1368, 1369 (1929); *Franklin Lumber & Power Co.,* 18 BTA 1207 (1930), affirmed on this issue but modified in another respect, 50 F.2d 1059 (4 Cir. 1931); *Herbert Simons,* 19 BTA 711, 712 (1930); *Clark Thread Co.,* 28 BTA 1128, 1150-51 (1933), affirmed 100 F.2d 257 (3 Cir. 1938); and *Thos. Goggan & Bro.,* 45 BTA 218 (1941). See *Duncan-Homer Realty Co.,* 6 BTA 730 (1927).

Rulings. There is also a series of administrative pronouncements in which depreciation to the date of sale seems consistently to have been recognized. I.T. 1158, I-1 C.B. 173 (1922); I.T. 1494, I-2 C.B. 1920-21 (1922); A.R.R. 6930, III-1 C.B. 45 (1924); G.C.M. 1597, VI-1 C.B. 71 (1927); the publication of *Rieck* v. *Heiner,* supra, at VII-1 C.B. 200 (1928); the Commissioner's acquiescence, supra, 1948-1 C.B. 3, in *Wier Long Leaf Lumber Co.,* on the automobile issue as well as on the mill issue; and the examples

in Reg. § 1.1238-1 which remain in substantially the same form since the issuance of T. D. 5851, 1951-2 C.B. 63.

We recognize, of course, that the Commissioner may change his interpretation of a statute to correct a mistake of law. *Automobile Club* v. *Commissioner*, 353 U.S. 180, 183-4 (1957); *Stevens Bros. Foundation, Inc.* v. *Commissioner*, 324 F.2d 633, 641 (8 Cir. 1963), cert. denied 376 U.S. 969. And the Commissioner would detract from the significance, if any, of these cases and rulings by urging (a) that most of them appeared in the 1920's; (b) that none occurred later than 1942 when capital gain rates were made applicable to favorable dispositions of certain business assets; (c) that in every reported case since 1942 the Commissioner has opposed the deduction; (d) that in some of these the taking of depreciation to the date of sale was no more than a "mere recitation"; and (e) that the regulations' examples, while "unfortunate" and an "inadvertency", are not in the section on depreciation and are not intended as an illustration of proper depreciation allowances.

Summary. We thus have a situation where (a) the statutes and the regulations do not, in so many specific words, resolve the situation before us; (b) the successive revenue statutes have shown a disposition on the part of Congress not to tamper comprehensively with final year depreciation; (c) the Supreme Court's guidelines do not afford a definitive answer to our present question; (d) the Commissioner and the courts for some time, at least, accepted depreciation in the favorable-sale year; (e) the Tax Court in *Wier* in 1947 and the Sixth Circuit in *Cohn* in 1958 upheld a redetermination of salvage value when a favorable sale took place at or near the end of the originally intended and estimated useful life; (f) nevertheless,

the Tax Court in *Wier* also approved final year depreciation on automobiles sold in midlife; (g) three district courts have approved and one has disapproved year-of-sale depreciation; (h) the Second Circuit, dividedly, has upheld disallowance of such depreciation; and (i) the Tax Court, by an 11 to 5 vote, has disagreed with the Second Circuit's reasoning, has overturned one of its recent single judge opinions, and has reaffirmed the *Cohn-Wier* distinction.

All this, we suspect, leaves us free to do our own groping in the dark.

The government's position, as we understand it, is as follows: (a) "[T]here could be no clearer and more compelling basis for a redetermination of useful life than the known fact that the asset has been withdrawn from the business and sold at a time earlier than estimated". Also, "Useful life is not a shifting concept. Either it is defined as the full economic life or as being terminated upon resale. It cannot be both". (b) It is unrealistic and absurd to say that an asset depreciates in the very year when the taxpayer by a sale actually recovers more than its adjusted basis at the beginning of that year. (c) It is even more unrealistic to allow an income tax depreciation deduction when the taxpayer, by the sale plus earlier allowed depreciation, has already recovered its cost. (d) Depreciation is the tax-free recovery of cost permitted to the taxpayer because of the use and consumption of assets producing the business income which is taxed. It is not to be misused so as to effect a conversion with consequent tax benefit, due to the interplay of statutes, of what is ordinary income into capital gain. (e) Here, with a favorable sale in excess of basis, there is no consumption of cost whatsoever during the sale year. Thus, there can

be no depreciation. Instead, and in contrast, there is realized appreciation. (f) Salvage value is sale price. (g) In any event, a deduction for depreciation must be reasonable. (h) Reasonableness is to be determined "upon the basis of conditions known to exist at the end of the period for which the return is made". Reg. § 1.167(b)-(O) (a). Here the end of the taxpayer's fiscal year was August 31, 1956. By then the sale had been effected and closed and existing conditions revealed its favorable character and substantial gain for the taxpayer. (i) Any claim for depreciation asserted in the sale year when the sale price exceeds adjusted basis at the beginning of the year is unreasonable on its face. (j) The language of Reg. § 1.167(a)-1(c), which speaks of salvage value as determined at the time of acquisition, which denies a change therein merely because of price level fluctuations, and which acknowledges the possibility of a redetermination of salvage value where there is a redetermination of useful life, "is obviously concerned only with the development of reasonable estimates during the difficult period *before* actual useful life and salvage value become known". The Commissioner has taken this position formally in a published ruling. Rev. Rul. 62-92, 1962-1 C.B. 29.[10] (k) Salvage

[10] "The provision in section 1.167(a)-1(c) of the regulations to the effect that salvage value shall not be changed at any time after the determination made at the time of acquisition merely because of changes in price levels applies to assets still on hand. The provision does not preclude adjustment of salvage value where there is a clear and convincing basis therefor even though no adjustment of useful life is required. The purpose of the provision is to eliminate needless and endless controversies over depreciation allowances which at best are merely informed estimates of the cost of using the property in the taxpayer's business. That purpose has been served when the asset is disposed of and when a final transaction has occurred over which there can be no dispute or difference of opinion or judgment. . . . [I]t is not only reasonable but proper to take the ultimate facts into consideration in determining the depreciation deduction for the year of disposition of the asset. Therefore, the deduction for depreciation of an asset used in the trade or business or in the production of income shall be adjusted in the year of disposition so that the deduction, otherwise properly allowable for such year under the taxpayer's method of accounting for depreciation, is limited to the amount, if any, by which the adjusted basis of the property at the beginning of such year exceeds the amount realized from sale or exchange."

value may be redetermined without a redetermination of useful life. The language of Reg. § 1.167(a)-1(c) is not a contrary restriction. (l) A sale, under the circumstances of this case, automatically redetermines useful life. (m) Price received at an actual sale is not a mere change in price level. Instead, it conclusively effects a change in salvage value and this directly affects the depreciation allowance.

There is, as the Tax Court said in *Macabe*, supra, "a beguiling appeal" in the government's contention. Judge Devitt seems to agree when he said, p. 679 of 218 F.Supp., "At first blush, it would appear that the taxpayer is attempting to ride with the hares and hold with the hounds, and thus to unjustly enrich itself. . . ." And Mr. Justice Harlan, at p. 107 of 364 U.S., prefaced his opinion of dissent and concurrence in *Massey* with a reference to "what may be thought to be an appealing practical position on the part of the Government".

It would seem, offhand, that the issue presented by the simple and undisputed facts of this case should be of no greater consequence than a straightforward routine income tax accounting matter obviously to be resolved by consistent treatment in each of the calendar years in which the assets are held, including the first and the last, and that this would justify the deduction of depreciation in the year of midlife sale. Yet this apparent simplicity of solution has not been forthcoming. Instead, we are confronted with the complicated and detailed mixture of statutes, legislative history, regulations, cases, and rulings which we have attempted to outline. This background and the length and vigor of the opposing arguments disclose that the question is taken to be close and difficult. We venture to say that much of the trouble, if the question is a difficult one, is attributable not to the governing

statute, which is most general in its terms, but to the consistent failure of the regulations to be definite and specific upon this ever-recurring final year question.

After earnest consideration of all the arguments which have been advanced upon us by the contending parties, we reach the conclusion that, on the facts here presented—unanticipated and non-customary sale in mid-life of a depreciable asset; acceptance of the correctness and reasonableness of the taxpayer's acquisition estimates of useful life and salvage value; actual approval of depreciation based on these estimates in prior years, some of which still remained open; and the inescapable inference that the claimed depreciation would have been allowed for the sale year had the sale not taken place—the taxpayer has sustained its burden of proof and is entitled to the deduction. We reach this conclusion because we feel that the following in the aggregate are persuasive:

1. The facts here possess impressive strength. The taxpayer's sale of its outboard motor assets was a sale of a going business. It acquired those assets and continued to hold them with, at all times, the intent to keep and utilize them in its business until the end of their economic life. It did not intend to dispose of them in the midst of that life and it had established no practice of early disposal, as was the situation in both *Massey* and *Hertz.* No challenge is made as to the correctness of the acquisition estimates of useful life and salvage value at the end of that life. The Commissioner accepted these estimates for all prior tax years and would have accepted them for fiscal 1956 had the sale not taken place in that year.

2. Cost or other basis, that is, the taxpayer's investment, not sale price, is depreciation's anchor. Both the statute,

§ 167(f) [§ 167(g), since the Revenue Act of 1962] and Reg. §§ 1.167(a)-1(a), 1.167(f)-1, and 1.167(b)-(0)(a) emphasize cost or other basis. Replacement of that investment by appropriate current charges against business income is the purpose of the depreciation deduction. *Detroit Edison*, supra, p. 101 of 319 U.S. (footnote ..., supra); *Ludey*, supra, p. 301 of 274 U.S. (footnote ..., supra); *Massey*, supra, p. 104 of 364 U.S.

3. The emphasis is on the taxable year as a unit and depreciation is to be taken in each year of the depreciating asset's useful life. Reg. § 1.167(a)-10(a). "Congress has elected to make the year the unit of taxation. . . . Thus the amount 'allowable' must be taken each year. . . . Congress has provided for deductions of annual amounts of depreciation which, along with salvage value, will replace the or' inal investment of the property at the time of its ret -ment". *Virginian Hotel Corp.* v. *Helvering*, supra, pp. 526 and 528 of 319 U.S. "Finally, it is the primary purpose of depreciation accounting to further the integrity of periodic income statements. . . ." *Massey*, supra, p. 104 of 364 U.S.; *Hertz*, supra, p. 126 of 364 U.S. "[I]t is sound accounting practice annually to accrue . . ." *Detroit Edison*, supra, p. 101 of 319 U.S.; *Ludey*, supra, p. 301 of 274 U.S.

4. This emphasis on the tax year as a unit extends to the year in which the depreciable asset is retired. A proportionate part of a year's depreciation is then allowable for that last year. Reg. § 1.167(a)-10(b). The asset continues to depreciate in the hands of the taxpayer right up to the date of sale. At that date it is older, more worn, and possessed of shorter economic life.

5. Straight line depreciation depends upon three factors, cost or other basis, useful life, and salvage value. Cost

or basis is known. Useful life and salvage value are estimates and are seemingly independent of each other. *Massey*, so heavily relied upon by the government here, ends with the comment, p. 107 of 364 U.S.:

> "We therefore conclude that the Congress intended that the taxpayer should, under the allowance for depreciation, recover only the cost of the asset less the *estimated* salvage, resale or second-hand value. This requires that the useful life of the asset be related to the period for which it may *reasonably be expected* to be employed in the taxpayer's business. Likewise, salvage value must include *estimated* resale or second-hand value." [emphasis supplied]

This emphasizes cost, estimated useful life and estimated salvage. The Tax Court in *Macabe* recognized this when it said, p. ... of 42 T.C., "The essential concept underlying the depreciation allowance as set forth in section 167 is prediction or estimation." See, also, *Burnet* v. *Niagara Brewing Co.*, 282 U.S. 648, 655 (1931).

6. With no dispute here as to either cost or useful life, the case hinges on salvage value. But this is to be determined, not at the time of the asset's retirement, but at the time of acquisition. Reg. § 1.167(a)-1. Salvage value under certain circumstances may be redetermined as, for example, when useful life is properly redetermined. But it is not to be redetermined "merely because of changes in price levels". Reg. § 1.167(a)-1(c). The possibility of gain on retirement of a depreciable asset is contemplated. Sections 1002 and 1231 of the Code. Reg. § 1.167(a)-8 (a)(1). Thus, there is nothing inherently or inferentially wrong, taxwise, in the existence of gain or loss upon the unanticipated disposition of a depreciable asset in midlife. The assumption underlying depreciation is that it approximates current consumption. It is basically and ad-

mittedly an estimate and rarely ties in precisely to sale price. It perhaps would do so frequently if the market were fixed, rigid and known. But the market fluctuates and is not rigid. This fluctuation does not make recognized depreciation methods and the estimates required in connection therewith any less valid.

7. There is no absolute identity of salvage value with sales price. The one is not necessarily equivalent to the other. Neither the statute nor the regulations equate them or make an exception out of the sale year. The emphasis, as has been noted, is, instead, on the estimate of salvage value, on such estimate at acquisition, or redetermination as the exception, on the distinct possibility of gain or loss on disposition, and on divorcement of salvage value from price level fluctuations.

8. *Massey* and *Hertz* are not authority to the contrary. They hold merely that useful life in the hands of a taxpayer who has intended to dispose of the asset before the expiration of its entire economic life terminates at the time of his disposition and that depreciation is to be estimated and computed accordingly. This view is validated by the factual observation of Mr. Justice Harlan in his separate dissent-concurrence in *Massey*, p. 113 of 364 U.S.:

> "[E]ven the Commissioner does not contend that a taxpayer who *happens* to dispose of some asset before its physical exhaustion must depreciate it on a useful life equal to the time it was actually held. It is only when the asset 'may reasonably be expected' to be disposed of prior to the end of its physical life that the taxpayer must base depreciation on the shorter period."

9. Depreciation and capital gain or loss are separate concepts in the income tax law although, of course, the

one necessarily affects the other. The former in theory rests on a base independent of market fluctuations. The latter is aimed at those fluctuations. This dichotomy is inherent in the statute. It is defeated and ignored if depreciation is inevitably to be tied to sale price. The two concepts are easily confused for we tend to use the word "depreciation" not only in the sense of consumption but, as well, in the sense of a downward market fluctuation.

10. On the facts before us those provisions of Reg. § 1.167(b)-(0)(a) which deny depreciation beyond cost less salvage value and which determine the reasonableness of a claim for depreciation upon "conditions known to exist at the end of the period" do not defeat this taxpayer's claim for depreciation. Of course, a favorable sale price might, in some instances, be a factor indicative of acquisition-estimate error. But this is not necessarily so and, it seems to us, is distinctly not so where, as in this case, there has been and still is no challenge as to cost and as to the useful life and salvage value acquisition estimates. The propriety of all three factors is accepted. The lack of challenge to the taxpayer's claimed and parallel depreciation deductions in prior tax years which were still open for audit adjustment is a concession to their propriety.

The government pins its case, instead, on the happy fact that the sale price exceeded beginning-of-year basis and it says that depreciation for the final year must therefore be "unreasonable". The favorable sale, however, does not serve to deny the correctness of the taxpayer's cost or the propriety of its useful life estimate or the propriety of its salvage value estimate. It does show that the market at the time of sale turned out to be different than that estimated. The difference may be due entirely to a fluctuating market or to other causes such as general inflation, a

buyer's market, or the availability of the asset for more productive alternate uses. 48 Minn. L. Rev. 628, 635 (1964).

The government gives some emphasis to the fact that the sale price exceeded not only adjusted basis at the beginning of the year but, as well, the original acquisition cost. Presumably it does so in the thought that this demonstrates extreme unreasonableness of the claimed final year depreciation. But, with no challenge to the acquisition estimates, the fact's significance may well be the other way. That sale price exceeds acquisition cost may tend to show that there was no element at all of unreality in the original estimates, which were necessarily based on cost, and that the excess is obviously due, instead, to market change.

11. This is not a situation where the assets are sold at or near the very end of useful life in the taxpayer's hands. When such time identity is present and is accompanied by excess of sale price over estimated salvage value, there may be justification in a given case for the disallowance of final year depreciation. This disallowance would then have to be based on a proper redetermination as of that time of the originally estimated salvage value. This is something more than the happenstance of a favorable sale price. It is this, as we read those opinions, which underlies the rationale of *Cohn* and *Wier* (the mill issue). *Wier's* decision on the automobile issue stands in glaring contrast. It does not follow from *Cohn* and *Wier* that a favorable sale at the end of useful life compels a depreciation disallowance in all cases.

12. We have here, instead, an unanticipated sale in midlife. This record contains nothing which discloses any change in the economic life of the assets. The sale itself did not change this.

13. There is a logical inconsistency in the government's attack on year-of-sale depreciation and its allowance of the depreciation in preceding years still open for adjustment when the sale facts became known to the government. In justifying this, the government is forced into the position of paying its respects to our formalized and structured annual income tax reporting system. This illogic was recognized by the Second Circuit in *Fribourg* and by the dissenters in both *Fribourg* and *Motorlease* and is illustrated by the apparently overruled *Rouse*, where the Tax Court disallowed depreciation on houses sold but allowed it in the same year on similar houses unsold. As has been said in *3 Rabkin and Johnson, Federal Income, Gift and Estate Taxation*, § 43.14, p. 4397m, "The Service has unjustifiably extended the rationale of the *Massey* and *Cohn* cases into a blanket rule that depreciation is to be disallowed for the year of sale whenever the selling price exceeds the depreciated basis at the beginning of the year".

The same illogic would be illustrated, too, if a sale, largely negotiated during one tax year, is closed within the first week of the succeeding tax year. The taxpayer, when his return for the prior year is later prepared and filed, certainly knows the sale facts. Yet the Commissioner, seemingly, would allow depreciation for the year of negotiation but disallow it for the sale year. Compare *Smith Leasing Co.*, supra, 43 T.C. No. 5 (1964). If "reasonableness" of depreciation is to be determined in the light of the sale price, the claimed deduction would seem just as unreasonable for the taxpayer in the negotiation year as in the sale year. To say, under these assumed facts, that the conditions were not known to exist at the end of the negotiation year lends support to the claim that the Commissioner's disallowance for the sale year is distinctly and solely related to the fact of the fortuitous sale.

14. The government's present position exceeds that taken by it in the one case *(Evans)* covered by the *Massey* opinion, for there the Commissioner did not precisely identify sales price with salvage value. There the Commissioner was not trying to eliminate all interplay between § 167 and § 1231. Here he would take that extra footage.

15. The government's position seems to emphasize hindsight and to abandon the concept that depreciation rests on prospective estimates which, to be sure, must be reasonable. It would, to use Judge Blumenfeld's words in *Motorlease*, p. 363 of 215 F.Supp., "set up an automatic hindsight re-evaluation which becomes a self-executing redetermination of salvage value triggered by the sale of depreciable assets".

16. There is no suggestion of tax evasion or, even, of tax avoidance here and no element of double deduction. Depreciation in the year of sale, while beneficial to this taxpayer in reducing ordinary income, is detrimental to it in increasing gain.[11] Nothing escapes taxation. That there is a difference in the tax rate upon ordinary income and the tax rate upon capital gain is an incident of the tax scheme which Congress saw fit to adopt for the year in question. It is not an escape hatch and to characterize it in terms of deliberate transmutation of ordinary income into capital gain seems unfair.

17. There is at least some significance in the recognition, over a long period of time, in many cases, including one of our own, in rulings, and in the regulations' examples

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[11] This was not the case in *Fribourg*, supra. There a complete liquidation was effected and, as the Second Circuit noted, it "came within the sanctuary of Section 337" of the 1954 Code. Thus, that corporate taxpayer incurred no tax liability on the capital gain. The same is apparently true of *Macabe*, supra.

still outstanding today, of depreciation as a deduction in the year of favorable sale. It is true that the regulations' examples are not in the sections dealing with depreciation, and that until 1942 it made no difference in tax whether the amount of claimed depreciation did or did not serve to reduce ordinary income with consequent increase or no change in sale gain. Nevertheless, we suspect that this long-continued practice and recognition, administrative and decisional, is indicative of the Commissioner's attitude and demonstrates that he felt this was correct and proper income tax accounting and in line with accepted business principles. It was only when the difference in tax impact entered the law that his change in attitude came about. This would seem to be attributable, not to a reevaluation of what is proper tax accounting, but to the fact that the new point of view, if it could be upheld, would result in greater tax.

18. There is some significance, also, in Congress' persistent failure directly to attack final year depreciation by way of statutory amendment. It was content, instead, to recharacterize gain with which it was dealing as ordinary income. And the 1962 and 1964 additions of §§ 1245 and 1250 to the 1954 Code were made to operate only prospectively. They do not purport to restate preexisting law.

19. We have deep respect for the conclusions reached by the Second Circuit majorities in *Fribourg* and *Motorlease*. But we cannot escape the feeling that the results in those cases underestimate both the law's dichotomy of approach to depreciation and to capital gain and, as well, the fact distinction, so apparent in *Wier* and so inherent in *Cohn*, between an intended sale of depreciable assets at or near the end of useful life and an unanticipated sale in midlife. To us, and obviously to the substantial Tax Court

majority in *Macabe*, these appear to be important and significant.

We mention, by way of caveat, that we do not, by our conclusion here, hold that salvage value may never be redetermined in the year of sale or, conversely, that in every case depreciation must be allowed in the sale year; that we do not decide the question whether redetermination of salvage value may be effected only when there is a redetermination of useful life, as the taxpayer insists is the case under Reg. § 1.167(a)-1(c), and as the district court held; and that we do not say that the facts in *Fribourg* and *Motorlease*, on the one hand, and those in *Macabe*, on the other, are so distinguishable that the results in all three cases are entirely consistent.

We conclude that this good-faith taxpayer's claimed deduction for depreciation on the sale assets in its fiscal 1956 return was a proper deduction under § 167 of the 1954 Code. The district court's judgment is therefore affirmed.

Van Oosterhout, Circuit Judge, dissenting.

Judge Blackmun has fairly stated the facts and has admirably assembled all the background material pertinent to the decision of this case. He has adequately set out the respective contentions of the litigants and the statutes, regulations and decisions bearing upon the issue confronting us.

I agree that the taxpayer's estimates of cost, useful life and salvage value were reasonable when made. I do not question the finding that the depreciation claim here as-

serted is based upon well-established and recognized accounting practices. The depreciation claimed and allowed prior to the sale year is entirely proper and is not here attacked.

The narrow issue before us is whether it is reasonable to allow a deduction for depreciation in the year in which the depreciating assets are sold when it conclusively appears during the taxable year that the sale price exceeds the adjusted basis at the beginning of the taxable year.

Section 167(a) authorizes a reasonable deduction for depreciation. I agree with Judge Blackmun's view that the statute and the regulations do not by specific words resolve our problem. As pointed out by the majority opinion, distinguished and able judges have reached opposite results. A decision by the Supreme Court on the issue would appear to be desirable to resolve this controversy.

I disagree with the court's conclusion that the depreciation claimed for the sale year is reasonable under all the circumstances here existing. "Reasonable" is a flexible word. The reasonableness of the depreciation allowance here claimed is to be determined upon the basis of conditions known to exist at the end of the taxable year for which the return is made. It is not reasonable to say that depreciation is allowable in the sale year when it conclusively appears during such year that the taxpayer has already recovered more than its adjusted basis at the beginning of the year. I do not believe that Congress in providing for reasonable depreciation contemplated that any further depreciation should be allowable in the situation here presented. The overall pattern of the income tax laws is entitled to consideration. The tax consequences of

allowing the additional depreciation claimed cannot be ignored in applying a test of reasonableness.

I am in accord with the interpretation made of the depreciation statute and regulations by the separate panels of the Second Circuit in *Fribourg Nav. Co.* v. *Commissioner,* 2 Cir., 335 F.2d 15, and *United States* v. *Motorlease Corp.,* 2 Cir., 334 F.2d 617.

I would reverse upon the basis of the majority opinions in such cases.

A true copy.

Attest: Robert C. Tucker

Clerk, U. S. Court of Appeals, Eighth Circuit.

In the Supreme Court of the United States

OCTOBER TERM, 1964

No. 679

FRIBOURG NAVIGATION COMPANY, INC., PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

MEMORANDUM FOR THE RESPONDENT

The question presented by this case is whether the resale price received upon the sale of an asset may be treated by the Commissioner as its salvage value in computing allowable depreciation for the year in which it was sold—with the result that the Commissioner, under the provision of the Treasury Regulations which prohibits depreciation of an asset be-

low its reasonable salvage value,[1] may deny all or any part of the claimed deduction for that year which would depreciate the asset below the actual price received. The Second Circuit, both in the instant case and in *United States* v. *Motorlease Corp.* (also pending on petition, No. 685), has given blanket approval to such action by the Commissioner. The Eighth Circuit, on the other hand, has denied this broad authority to the Commissioner in *United States* v. *S & A Co.* (a case in which the government proposes to request certiorari),[2] although the court indicated that the action might be taken in certain cases, *e.g.*, where the sale was made at or near the end of the estimated useful life. It is the Eighth Circuit's view that the income tax depreciation is intended to be an allowance for the wear and tear sustained by an asset through use and that, since the favorable resale price received may be the result of fluctuations in market values—which the court regarded as a factor extraneous to the depreciation system—the resale price was to be ignored, at least in the case of an unplanned sale in the middle of the originally estimated useful life.

We agree with petitioner that the issue involved here is important and heavily litigated; that there is

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[1] See Treasury Regulations on Income Tax (1954 Code), Section 1.167(a)-1(a) and (c), as amended by T.D. 6507, 1960-2 Cum. Bull. 91.

[2] The opinion in that case is set out in the appendix to the instant petitioner's Supplemental Memorandum in Support of Petition For a Writ of Certiorari.

a conflict between the holdings of the Second and Eighth Circuits;[3] and that the matter is one which calls for resolution by this Court. Accordingly, we acquiesce in a grant of the writ.

Respectfully submitted,

ARCHIBALD COX,
Solicitor General.

JANUARY, 1965.

[3] We do not agree, however, that there is any conflict between the holding of the Second Circuit and that of this Court in *Massey Motors* v. *United States*, 364 U.S. 92.

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1965

No. 23

FRIBOURG NAVIGATION COMPANY, INC., *Petitioner*

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent*

On Writ of Certiorari to the United States Court of Appeals for the Second Circuit

BRIEF FOR THE AMERICAN AUTOMOTIVE LEASING ASSOCIATION AS AMICUS CURIAE

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INDEX

CITATIONS

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BRIEF FOR THE AMERICAN AUTOMOTIVE LEASING ASSOCIATION AS AMICUS CURIAE

THE INTEREST OF THE AMERICAN AUTOMOTIVE LEASING ASSOCIATION

This brief as *amicus curiae* is submitted on behalf of the American Automotive Leasing Association with the written consent of both parties. The letters consenting to the filing of the brief have been filed in the office of the Clerk.

The American Automotive Leasing Association was organized on November 25, 1955 as a non-profit cor-

poration under the laws of the State of Illinois. It is a trade association composed of long-term automotive leasing companies engaged in the business of leasing automobiles to commercial and industrial lessees for periods of one year or more. A recent survey of the Association membership disclosed that the member companies had on lease approximately 260,000 vehicles representing an investment of approximately $700,000,000.00.

Automotive leasing companies purchase vehicles new from automobile dealers. These new vehicles are then leased in volume to commercial and industrial lessees who operate them in their businesses. Upon the expiration of the lease periods, the vehicles are returned to the lessors, who generally dispose of them at wholesale, sometimes to used car dealers, sometimes at auctions. Since most of the member companies of the Association have lessees in many states, the cars are not usually returned to the home offices of the lessors for disposition, but are sold, most of the time, at or near the places where the lessees had been operating them. Vehicles are not leased a second time as used cars.

While the vehicles are on lease, they are, for tax purposes, property used in the business of the lessor (see *Hillard* v. *Commissioner,* 281 F.2d 279 (C.A. 5); *Philber Equipment Corp.* v. *Commissioner,* 237 F.2d 129 (C.A. 3)), and a depreciation deduction for each vehicle is taken pursuant to section 167 of the Internal Revenue Code of 1954. When the vehicles are disposed of at the termination of the leases, the gains realized or losses sustained are handled in accordance with the provisions of section 1231 of the Code—any gains realized over the depreciated basis of the vehicles

at the time of sale being entitled to capital gains treatment.[1]

It is thus apparent that the resolution of the issue involved in this case—which concerns the validity of the Commissioner's disallowance of the deduction for depreciation during the year in which an asset is sold and while it is still in use in the taxpayer's business—is of vital interest to the members of the American Automotive Leasing Association. The case of *The Motorlease Corporation* v. *United States* (No. 24, Oct. Term, 1965), pending in this Court on petition for a writ of certiorari, which was decided by a different panel of the court below on the same day as the decision in the instant case "on the authority of, and for the reasons given" in the opinion in the instant case (334 F.2d 617, 618), involves the application to automotive leasing companies of the basic legal principles at issue in this case. Petitioner in *The Motorlease Corporation* case is a member of the American Automotive Leasing Association, and as the petition for a writ of certiorari in that case points out (Pet. p. 21), many automotive leasing companies have cases pending within the Internal Revenue Service involving the same issue. The Association appeared *amicus curiae* in the *Motorlease* litigation in both the District Court for the District of Connecticut and in the court below.

This brief on behalf of the American Automotive Leasing Association urges rejection of the principles

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[1] This, of course, relates only to dispositions in years prior to taxable years beginning after December 31, 1962, which is the effective date of section 13 of the Revenue Act of 1962 (P.L. 87-834, 76 stat. 960) adding new section 1245 to the Internal Revenue Code of 1954.

adopted by the court below in this case and in *Motorlease* for reasons which will be hereinafter set forth in detail.

STATUTE AND REGULATIONS INVOLVED

Section 167 of the Internal Revenue Code of 1954 and the pertinent provisions of the depreciation regulations issued thereunder are set forth in Appendix A, *infra,* pp. 1a to 7a.

SUMMARY OF ARGUMENT

A. The Commissioner of Internal Revenue may not adopt a rule of law disallowing a taxpayer's otherwise reasonable claim for a depreciation deduction for the year in which a depreciable asset is disposed of, solely because the asset is sold for more than its adjusted basis. Section 167 of the Internal Revenue Code of 1954 affords a taxpayer a "reasonable allowance" as a "depreciation deduction" from income, in order to return to him, tax free, the approximate cost of the use of an asset in his trade or business. Further, section 1231 of the Code provides that, upon the sale of depreciable property used in a taxpayer's business for more than six months, the excess of selling price over the depreciated basis of the asset shall be treated, for tax purposes, on a capital gains basis. There is nothing in the statute which requires or suggests any different accounting for depreciation for the year in which an asset is sold.

The Commissioner's regulations, issued pursuant to section 167, set forth in detail how the "reasonable allowance" for depreciation is to be established by the taxpayer. The taxpayer first *estimates* the period over which the asset may reasonably be expected to be

useful to him in his trade or business—the period of useful life. He then *estimates* the salvage value of the asset—an estimate of the amount which will be realizable upon sale of the asset at the end of its estimated useful life. Estimated salvage value, it should be noted, is not the selling price. And, finally, he establishes, as the "reasonable allowance" for depreciation, the cost of the asset less its *estimated* salvage value, to be spread over its estimated useful life. The regulations provide further that depreciation begins when an asset is placed in service and ends when the asset is retired from service. The limit below which an asset may not be depreciated is specifically stated to be the reasonably estimated salvage value and not the amount received upon the sale of the asset, as the Commissioner now contends.

The regulations provide further that the estimate of salvage value is not to be changed because of a change in price levels; and depreciation is to continue at the reasonable rate established, with any gains or losses arising upon the sale of the asset to be accounted for in accordance with sections 1002, 1231 and other provisions of the Code dealing with gains or losses upon disposition of property.

There is, thus, no provision in the regulations which authorizes the Commissioner to disturb, in the year of sale, a concededly reasonable depreciation plan simply because an asset is disposed of for more than its depreciated basis. Indeed, the Commissioner's own regulations deny him this authority.

B. The authority claimed by the Commissioner to disallow a reasonable deduction for depreciation for the year of sale solely because an asset is sold for more than its depreciated basis is in conflict with the prin-

ciples affirmed by this Court in *Massey Motors Inc.* v. *United States* and *Commissioner* v. *Evans,* 364 U.S. 92. In those cases, this Court pointed out that the Congress intended a taxpayer to recover, under the allowance for depreciation, the cost of the asset less its *estimated* salvage value. "This requires that the useful life of the asset be *related* to the period for which it may *reasonably* be expected to be employed in the taxpayer's business. Likewise, salvage value must include *estimated* resale or second-hand value." 364 U.S. at 107 (Italics supplied). The Court specifically recognized that any gains realized upon the sale of depreciable assets were treated as capital gains. 364 U.S. at 97. In *Evans,* depreciation deductions during the year of sale were permitted down to *estimated* salvage value and below the actual selling price, and capital gains were thereby created and permitted during the year of sale. Indeed, the arguments made by the Commissioner himself in *Massey Motors* and *Evans* were inconsistent with the position he now asserts here.

Neither panel of the court below even referred to this Court's decision in *Massey Motors* and *Evans,* although many other courts have relied upon it in rejecting the Commissioner's contention.

In any event, apart from the decisions below and a decision of the Federal District Court for the Eastern District of Tennessee, every court which has considered the Commissioner's contention has now rejected it. The decision in *Cohn* v. *United States,* 259 F. 2d 371 (C.A. 6), relied on by the Commissioner, has not persuaded other courts to the Commissioner's point of view, and that case has been either distinguished on its facts or criticized as wrongly decided. Moreover, the Commissioner's contention has been widely criticized by the writers.

C. The Commissioner's contention violates basic accounting principles. It is the basic purpose of depreciation accounting to make a meaningful allocation of the cost of the use of an asset—the cost less its estimated salvage value—to the tax periods benefited by the use of the asset. Such an allocation is essential in order to determine net income accurately for any given period, and it is accepted accounting practice to allocate the cost less estimated salvage value over the entire period of estimated useful life. As a matter of accounting practice, appreciation in the value of an asset is not offset against depreciation. These well-settled principles were affirmed in the earliest decisions of the Board of Tax Appeals which required that a depreciation deduction be taken until the date of sale of an asset in order to determine the basis of the property for purposes of establishing gain or loss on disposition. There was not the slightest suggestion that depreciation could not or should not be taken in the year of sale if to do so would reduce the basis below selling price. And in *United States* v. *Ludey,* 274 U.S. 295, this Court held that depreciation must be deducted up to the date of sale for purpose of establishing gain.

The Commissioner's arbitrary rule of law excludes the last year of an asset's use from the period of depreciation, notwithstanding that during that year the asset is in use in the taxpayer's business, represents a cost of doing business during that year, as in any other year, and contributes to the receipt of income during that year. This arbitrary rule violates the basic principle that depreciation accounting is intended to allocate meaningfully the cost of an asset's use to all periods to which such use contributes and, additionally, it conflicts with the Commissioner's own require-

ment that depreciation shall end when an asset is *retired* from service.

The Commissioner's rule results in a distortion of income by understating income for years prior to the year of sale and overstating income for the year of sale. In addition, the Commissioner's contention would make depreciation accounting, and resulting income statements, depend on wholly artificial and arbitrary circumstances, for a taxpayer can avoid the impact of the rule by merely holding an asset until shortly after the beginning of a new tax year and then disposing of it. In these cases, every penny of disallowed depreciation could have been retained, on the Commissioner's own theory, if the assets were held for short periods into new tax years. The Commissioner's rule of law not only fails to further the integrity of periodic income statements, which is the real purpose of depreciation accounting, but, additionally, it penalizes the careful taxpayer and invites abuse of the depreciation concept by providing an incentive to take larger depreciation deductions during the years prior to the year of sale, thereby creating capital gains which the Commissioner's theory permits to be retained. A more strained and perverse interpretation of sound depreciation practice is difficult to imagine.

D. In 1942, the Congress added section 117(j) to the Internal Revenue Code of 1939 providing for the capital gains treatment of gains realized upon disposition of depreciable assets. This provision was reenacted without substantive change as section 1231 of the Internal Revenue Code of 1954. As we have shown, it was accepted accounting practice, confirmed by the earliest decisions of the Board of Tax Appeals and decisions of this Court, for depreciation to be taken for

the entire period of an asset's use up to the date of its sale, in order to establish the gain or loss upon sale. There is nothing in section 117(j) or its history to suggest that the Congress intended to include within the scope of section 117(j) only those gains developed by depreciation deductions in the years prior to the year of sale. There is no suggestion of any purpose to depart from accepted practice.

Thereafter, on many occasions in connection with deliberations on a variety of legislative proposals, the Congress was warned of the revenue losses sustained by the Treasury because of the capital gains rates applicable to dispositions of depreciable assets. Neither in the warnings nor in the Congressional statements was there even a suggestion that what was involved was only those capital gains that might be developed by deductions for depreciation prior to the year of sale. On the contrary, it is clear that the Congress considered the problem in the light of revenue losses resulting from the applicability of capital gains rates to gains resulting generally from the sale of depreciable assets where deductions had been taken up to the date of sale in the year of sale. Nevertheless, the Congress refused to amend the law in this regard until 1962 when section 1245 was added to the Internal Revenue Code of 1954, treating as ordinary income the gain realized on the sale of depreciable property, during taxable years after December 31, 1962, to the extent of depreciation taken prior to December 31, 1961. This legislation was not retroactive. This course of activity, or inactivity, by the Congress makes it plain that the Commissioner has attempted, by his ruling in these cases, to accomplish what the Congress had refused to permit for so long a period of time.

ARGUMENT

WHERE A DEPRECIATION PLAN FOR A DEPRECIABLE ASSET IS ADOPTED BY A TAXPAYER IN ACCORDANCE WITH THE PROVISIONS OF SECTION 167 OF THE INTERNAL REVENUE CODE OF 1954 AND THE COMMISSIONER'S REGULATIONS, AND IS CONCEDED TO BE REASONABLE, THE TAXPAYER IS ENTITLED TO A DEPRECIATION DEDUCTION FOR SUCH ASSET FOR THE YEAR IN WHICH IT IS SOLD FOR MORE THAN ITS ADJUSTED BASIS.

The single legal issue involved in this case concerns the right of a taxpayer to claim a depreciation deduction for a depreciable asset during the year in which he disposes of the asset at a price which exceeds its adjusted basis. The Commissioner contends that, during the year of sale of the asset, that part of the claim for depreciation which would reduce its adjusted basis below the selling price must be disallowed and, further, that if the adjusted basis of the asset at the beginning of the year of sale was already below the ultimate selling price, then all depreciation claimed during the year of sale of the asset must be disallowed.[2] The Commissioner's argument is quite simple, and, indeed, it has a "beguiling appeal" (*Macabe Co. Inc. et al.* v. *Commissioner,* 42 T.C. 1105, 1109). The purpose of

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[2] In the instant case, since the vessel was sold for more than its adjusted basis (book value) at the beginning of the year of sale, all depreciation during the year of sale was disallowed. *Fribourg Navigation Co.* v. *Commissioner,* 335 F.2d 15, 16 (C.A. 2). In the *Motorlease* case, some of the vehicles were sold for less than their adjusted basis at the beginning of the year of sale, but for more than their adjusted basis at the time of sale, and in those instances there was disallowed that part of the depreciation claimed during the year of sale which would reduce the adjusted basis below the selling price. See *United States* v. *The Motorlease Corporation,* 334 F.2d 617, 618 (C.A. 2). Hereinafter, when reference is made to the "disallowance" of depreciation during the year of sale, we refer to either the partial or total disallowance, depending on the adjusted basis of the asset at the beginning of the year.

the depreciation allowance, the argument goes, is to return to the taxpayer, tax-free, the net cost of using the asset in his business. When the asset is sold and its selling price becomes known, the net cost to the taxpayer of the use of the asset (the orginal cost less the known selling price) also becomes known, and any depreciation deduction, during the year of sale, which would reduce the adjusted basis below the actual selling price would return to the taxpayer an amount in excess of his net cost and must, therefore, be disallowed as beyond the proper scope of the depreciation allowance. In the Commissioner's view, it is immaterial that the taxpayer's depreciation plan had been approved by him, in advance, as in this case (335 F.2d 15, 16, 19), or is conceded to be reasonable in every regard, as in the *Motorlease* case (334 F.2d 617, 619), and it is similarly immaterial that the claimed depreciation may reduce the adjusted basis to only a few cents below the selling price.[3] The sole determining factor, in the Commissioner's view, is the fact that the asset is sold at a price which exceeds its adjusted basis.

We contend that the Commissioner's position is incorrect. It is our contention that, under section 167 of the Internal Revenue Code and the pertinent regulations issued pursuant thereto, a taxpayer must estab-

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[3] In the *Motorlease* case, for example, District Judge Blumenfeld pointed out that "in four specific instances in this case, the commissioner disallowed depreciation respectively of $0.03, $2.82, $2.33, and $4.70" *The Motorlease Corporation* v. *United States*, 215 F.Supp. 356, 361. (D.Conn.) In addition, in *Motorlease*, the taxpayer's depreciation plan resulted in losses being sustained upon the disposition of approximately one-third of the vehicles during the years involved. The details are set forth in the Petition for a Writ of Certiorari in that case (No. 24, Oct. Term, 1965), p. 4, n. 3.

lish a reasonable plan of depreciation for a depreciable asset designed to provide the "reasonable allowance" provided for in section 167. Having done that, the taxpayer is entitled to depreciate the asset from the time it is put into service in his business until it is disposed of.[4] So long as there is no challenge to the reasonableness of the plan, and there has been none either in this case or in the *Motorlease* case—the mere fact that the asset is sold for more than its adjusted basis affords no occasion to disallow year-of-sale depreciation. Any excess of sales price over adjusted basis in such a case is properly treated as a gain realized upon the sale of a depreciable asset and taxable as such at whatever rate may be applicable. This view, we contend, is in accord with basic and well-established principles of depreciation accounting; it results in none of the completely absurd consequences which, as we shall show, follow from the Commissioner's position; and, we submit, this view is precisely what the Commissioner's own regulations require.

A. The Commissioner's Denial of the Claimed Depreciation Deduction Is In Conflict With the Statute and the Commissioner's Own Regulations.

1. *The statute*—Section 167 of the Internal Revenue Code of 1954 permits a taxpayer to deduct from his income a "reasonable allowance" as a "depreciation deduction" for the property used in his trade or business. The provision, it should be emphasized, is for a "reasonable allowance"; it does not provide for a deduction of a specific amount limited to the original cost of an asset, less what is actually received upon its

[4] The asset, however, may not be depreciated below a reasonably estimated salvage value, a figure not to be confused with the actual ultimate selling price on disposition. See *infra*, pp. 17-18, 22.

ultimate sale.[5] The purpose of this "reasonable allowance" as a depreciation deduction is "to *approximate* and *reflect* the financial consequences to the taxpayer of the subtle effects of time and use on the value of his capital assets." *Detroit Edison Co.* v. *Commissioner,* 319 U.S. 98, 101 (Italics supplied). Mr. Justice Brandeis has stated that the depreciation allowance "is a bookkeeping device introduced in the exercise of practical judgment to serve three purposes. It preserves the integrity of the investment. * * * It serves to distribute equitably throughout the several years of service life the only expense of plant retirement which is capable of *reasonable ascertainment*—the known cost less the *estimated salvage value.* And it enables those interested, through applying that plan of distribution, to ascertain, *as nearly as is possible,* the actual financial *results of the year's operations.*"[6] (Italics

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[5] The deduction authorized has always been for a "reasonable allowance". This has been the definition since as far back as 1909. See section 23(1) of the Internal Revenue Code of 1939, 53 stat. 14; section 23(1) of the Revenue Act of 1938, 52 stat. 462; section 23(1) of the Revenue Act of 1936, 49 stat. 1660; section 23(1) of the Revenue Act of 1934, 48 stat. 689; section 23(k) of the Revenue Act of 1932, 47 stat. 181; section 23(k) of the Revenue Act of 1928, 45 stat. 800; sections 214(a)(8) and 234(a)7 of the Revenue Acts of 1926, 1924, 1921, and 1918, 44 stat. 27, 42; 43 stat. 270, 284; 42 stat. 240, 255; 40 stat. 1067, 1078; sections 5, Seventh and 12(a), Second, of the Revenue Act of 1916, 39 stat. 759, 768; sections II, B and II, G(b) of the Revenue Act of 1913, 38 stat. 167, 172; and section 38, Second, of the Special Corporate Excise Tax of August 5, 1909, 36 stat. 113.

[6] Mr. Justice Brandeis, dissenting in *United Railways & Electric Co.* v. *West,* 280 U.S. 234, 264. See *Federal Power Commission* v. *Hope Natural Gas Co.,* 320 U.S. 591, 606-607, disapproving the holding in the *West* case and referring with approval to Mr. Justice Brandeis's statement.

supplied.) This view is reflected in Mr. Justice Clark's more recent statement that "it is the primary purpose of depreciation accounting to further the integrity of *periodic* income statements by making a meaningful allocation of the cost entailed in the use (excluding the maintenance expense) of the asset *to the periods to which it contributes". Massey Motors, Inc.* v. *United States*, 364 U.S. 92, 104 (Italics supplied).

Since the depreciation deduction is a "bookkeeping device" which is entered currently in a taxpayer's accounts during the period that property is being used in the business in order to "reflect and approximate" the cost to the taxpayer of the use of that asset, and at a time when the actual net cost of its use cannot be known because it is not known what, if anything, might be recovered for that asset when it is ultimately disposed of, it becomes clear why the Congress has defined the deduction only as a "reasonable allowance" and has never changed the definition. To be sure, after the asset is finally disposed of, the specific amount recovered on its sale is ascertained, and the precise net cost to the taxpayer of the use of the asset over the entire period of its use also becomes known. And the Congress has dealt specifically with that event. It has provided specifically in section 1231 of the Internal Revenue Code of 1954 that, upon the sale of depreciable property used in a taxpayer's trade or business for more than six months, the excess of the selling price over the depreciated basis of the asset at the time of the sale shall be treated, for tax purposes, on a capital gain basis. To the extent that the asset is disposed of for less than its depreciated basis, the provisions of the Internal Code dealing with gains and losses on disposition of property apply. See Subchapter O of the Internal Revenue Code of 1954.

There is nothing whatsoever in the statutory provision for the "reasonable allowance" for depreciation which requires or in any way suggests a different handling or a different definition of depreciation for the year of sale of an asset. It would have been quite simple for the Congress to have added to section 167 a proviso that, during the year in which an asset is sold, no deduction for depreciation would be permissible after the total deductions equalled the original cost less the actual amount received on the sale of the asset. See Judge Moore, dissenting below, *Fribourg Navigation Co.* v. *Commissioner,* 335 F.2d at 20. But, as already noted, the statute does no such thing. Insofar as depreciation is concerned, it is treated no differently in the year of sale than in any other year. The consequences of the sale are reflected in the provisions of Subchapter O and of section 1231 of the Revenue Code of 1954 treating with the gains realized and losses sustained on the disposition of the asset.[7]

2. *The regulations*—On June 12, 1956, the Commissioner published in the Federal Register (21 F.R. 3985 *et seq*) the final regulations setting forth in detail how a taxpayer must establish the "reasonable allowance" for depreciation provided for in section 167 of the Internal Revenue Code (T.D. 6182, 26 C.F.R. 1.167(a) *et seq.*).[8] This was almost two years after the enactment of the Code on August 16, 1954. An examination

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[7] No change in principle has been made by the additions of section 1245 in 1962 and section 1250 in 1964 to the Internal Revenue Code of 1954. Only the rate of tax on certain portions of such gains has been changed.

[8] Hereafter, we shall refer to the regulations only by their section numbers, since these are the same as the section references in 26 C.F.R.

of these regulations, we submit, makes it abundantly clear that the Commissioner has failed to abide by his own regulations (see *Service* v. *Dulles,* 354 U.S. 363) and that both majority panels of the court below were in error when they approved of the Commissioner's disallowance of year-of-sale depreciation.

Section 1.167(a)-1(a) of the regulations defines the reasonable allowance for depreciation as the "amount which should be set aside for the taxable year in accordance with a reasonably consistent plan * * *, so that the aggregate of the amounts set aside, plus the salvage value, will, at the end of the estimated useful life of the depreciable property, equal the cost or other basis of the property." "Salvage value" is defined, not, as the Commissioner assumes, as the amount actually received upon the sale of an asset, but as "the amount (determined at the time of acquisition) which is *estimated will be realizable* upon sale or other disposition of an asset when it is no longer useful in the taxpayer's trade or business or in the production of his income and is to be retired from service by the taxpayer". Section 1.167(a)-1(c). It is further provided that the "*estimated* useful life of an asset is not necessarily the useful life inherent in the asset but is the period over which the asset *may reasonably be expected to be useful to the taxpayer in his trade or business.*" Sec. 1.167(a)-1(b). (Italics supplied) See *Commissioner* v. *Evans* and *Massey Motors, Inc.* v. *United States,* 364 U.S. 92 [9] and *Hertz Corp.* v. *United States,* 364 U.S. 122. And section 1.167(a)-10(b) provides that "The period for depreciation of an asset

[9] The *Evans* and *Massey Motors* cases were consolidated for argument in this Court. One opinion, 364 U.S. 92, was rendered for both cases, but the facts in each case were separately stated.

shall begin when the asset is placed in service and shall end when the asset is *retired* from service." (Italics supplied).

Thus, it is apparent that a taxpayer, in establishing the "reasonable allowance" for depreciation, must first *estimate* the period of the useful life of the asset in his business, must then estimate the salvage value of the asset as of the end of that period of useful life, and must then take, as a depreciation allowance, the cost less the *estimated* salvage value spread over the *estimated* useful life of the property in the business. The resulting depreciation allowance, which is based on two *estimated* figures, is itself, therefore, an *estimated* figure, determined at the beginning of the period of an asset's use; it is not, nor can it be, a precise figure which becomes known only after the sale of an asset, when both the precise period of its actual useful life and the precise amount of recovery upon its disposition become known.

It should be noted, moreover, that these provisions recognize that, although the recovery of cost of the use of an asset, tax free, may very well be the ultimate ideal to be achieved (see ***Massey Motors, Inc.* v. *United States,*** 364 U.S. 92, 96, "It was the design of the Congress to permit the taxpayer to recover, tax free, the total cost to him of such capital assets * * *"), this ideal would be accomplished only in the rare case. The regulations do not provide that the aggregate of the depreciation deductions plus the amount received upon disposition of an asset shall equal the cost of the asset which is to be returned tax-free. Instead, it is the sum of the depreciation deductions plus the amount "which is estimated will be realizable upon sale or other disposition of an asset" (see sections 1.167(a)-1(a), 1.167

(a)-1(c)) which must equal the original cost. In short, the regulations provide for a formula whose elements total the original cost of the asset to be returned tax free, but these elements are necessarily based on estimates; and, to the extent that the estimates are reasonable, the purpose of the statute and the regulations has been achieved.

It is the failure of the Commissioner and of the court below to appreciate what has been provided for in the Commissioner's own regulations that has resulted in the error of the court below. Just as with the statute, itself, it would have been quite simple for the Commissioner to have provided in his regulations that, during the year in which an asset is disposed of, no deduction for depreciation would be permissible after the total deductions equalled the original cost less the actual amount received on the sale of the asset.[10] But the fact is that the regulations do not so provide, and we submit, they do not so provide because at the time they were promulgated, there was an appreciation of the fact that it was a "reasonable allowance" that was being provided for rather than a rigid figure of original cost less actual recovery on sale.

Other provisions of the regulations support our view. In order to assure that a depreciation plan shall continue to be a reasonable one throughout the period of use of an asset and that the total deductions for the entire period of use shall achieve the statutory purpose of providing a "reasonable allowance," the regulations

[10] We, of course, do not concede that this would have been permissible under the statute. The Commissioner has, in effect attempted to do this in Rev.Rul. 62-92, 1962-1 Cum.Bull. 29, issued after the litigation in these cases was underway.

set forth rules for modifying depreciation plans when conditions change during the period of an asset's use. But, as we shall show, these provisions for modification authorize or require changes only in very limited circumstances. The regulations provide, in section 1.167(a)-1(b), for the modification of the "estimated *remaining* useful life" by reason of changed conditions known to exist at the end of a taxable year. "However, estimated *remaining* useful life shall be redetermined only when the change in the useful life is significant and there is a clear and convincing basis for the redetermination." Section 1.167(a)-1(c) provides further, moreover, that the estimate of salvage value "shall *not* be changed at any time after the determination made at the time of acquisition merely because of changes in price levels. However, if there is a redetermination of useful life under the rules of paragraph (b) of this section, salvage value may be redetermined based upon facts known at the time of such redetermination of useful life." (Italics supplied).

These provisions, we submit, emphasize the design of the regulations to accomplish the statutory purpose of providing for a "reasonable allowance" for depreciation over the years of an asset's use in the business; they foreclose, we submit, the Commissioner's contention, adopted by the court below, that the precise figure of cost less actual recovery on disposition of an asset is the total amount to be allowed. These provisions specifically instruct a taxpayer that a change in the price level of an asset during the course of its use, without more, should be disregarded insofar as the original salvage estimate and the depreciation allowance is concerned. Depreciation is to continue at the same rate quite apart from the rise in value of the

asset, and any gains or losses upon the ultimate disposition of the asset are made "subject to the provisions of sections 1002, 1231, and other applicable provisions of law" dealing with gains and losses on disposition of property. Sections 1.167(a)-8(a)(1). It is only when the estimated *remaining* useful life is changed that the estimated salvage value is to be revised, and the *remaining* useful life is subject to redetermination only if the change is "significant" and there is a "clear and convincing" basis therefor. See *Massey Motors, Inc.* v. *United States,* 364 U.S. at 105.

These provisions, in our view, are concerned with changes in estimates required in connection with the future continued use of the property and not with the year in which the property had been disposed of, and the Government does not contend otherwise.[11] The regulations can be searched in vain for any provision either directing the taxpayer or authorizing the Commissioner, during the year of sale, to change the salvage value estimate of a concededly reasonable plan of depreciation on the sole ground that the amount recovered on the sale of the asset has exceeded the estimated salvage value. The Commissioner purports to find the authority, not in any provision of the regulations, but in the mere assertion that, after the sale, the estimates are no longer of any significance and only the sale

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[11] In the Government's brief in *United States* v. *Wyoming Builders, Inc.,* No. 7861, pending on appeal in the United States Court of Appeals for the Tenth Circuit, it is stated (p.25): "The relevant portion of Section 1.167(a)-1(c) of the Regulations, proscribing salvage changes except when in conjunction with a redetermination of useful life, refers only to changes during the holding period of the asset—not a change resulting from termination of useful life by resale."

price controls. This means, then, that during the period of use of an asset, a taxpayer must continue to disregard known increases in the value of the asset, must continue to take annual depreciation allowances which, in all probability, will exceed the difference between the original cost of the asset and its ultimate resale price, and then, in the year of sale, must suddenly refrain from taking a depreciation deduction because the resale price must then be substituted for the estimated salvage value. This, we suggest, is absurd. If, as the Commissioner contends, the real purpose of the depreciation allowance was to return to the taxpayer only the difference between original cost and ultimate resale price, we suggest that his regulations would have required periodic changes in the estimate of salvage value. This would prevent gains on disposition from piling up over the years. But, apparently, when these regulations were drafted, the Commissioner appreciated that increases in the value of an asset were to be treated as gains on disposition of property and were not to be deemed occasions for altering an otherwise reasonable depreciation formula. The change in the value of the asset was to be disregarded during the period of the asset's use, and no sensible reason has been suggested for excluding the year of sale from that period of use.[12]

[12] Moreover, even if the provisions of sections 1.167(a)-1(b) and 1.67(a)-1(c) are deemed applicable to the year-of-sale, it is clear that they afford no support to the Commissioner's theory. His adjustment is made whenever the sales price exceeds the salvage value and is based solely on that fact—a fact which section 1.167(a)-1(c) specifically states can provide no basis for a change. And, insofar as the estimate of useful life is concerned, the Commissioner's theory makes no inquiry into whether a change is "significant" or whether there is a "clear and convincing basis" therefor.

Furthermore, when the Commissioner undertook, in his regulations, to fix the limit of the total amount of depreciation deductions permissible for an asset—and this necessarily included the year in which the asset is sold—he very carefully refrained from fixing that limit at the original cost less the amount recovered on resale. Instead, he provided that "An asset shall not be depreciated below a reasonable salvage value" (Section 1.167(a)-1(a); see also section 1.167(a)-1(c)), a limit which concededly has not been exceeded in either this case or the *Motorlease* case.[13]

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[13] In a brief filed by the American Automotive Leasing Association as *amicus curiae* in *Hillard* v. *Commissioner*, 281 F.2d 279 (C.A. 5), the Association stated its complete accord with the depreciation regulations. This brief was filed in this Court by the Government together with its own brief in *Commissioner* v. *Evans*, 364 U.S. 92, was quoted from with approval at pages 32-35 of the Government's brief, and was referred to in this Court's opinion. 364 U.S. at 105, n.6. With respect to determination of the depreciation allowance, the Association's brief in *Hillard* stated (pp. 11-12): "In order to assist its members in complying as strictly as possible with the requirements of proper depreciation practices and in making their estimates as accurate as possible, the American Automotive Leasing Association, at great expense, has retained the services of an outstanding firm of consulting economists. This firm has been making detailed and comprehensive studies for us of all the data and factors—economic and otherwise—which go into determining the wholesale price of a used vehicle at any particular period of time, and, based on these studies, has provided the Association with detailed reports prognosticating what, in its judgment, the wholesale price of a used leased vehicle would probably be at periods of one year, one year and a half, and two years after a fleet of cars had been put in leasing service by a leasing company. These reports have covered the three most popular cars in the industry, and, of course, are based upon the

In spite of the foregoing, the court below sustained the Commissioner's position on the basis of one single sentence contained in section 1.167(b)-(O)(a) of the regulations which provides that "The reasonableness of any claim for depreciation shall be determined upon the conditions known to exist at the end of the period for which the return is made". The argument is, apparently, that since, in the court's view, "At the end of 1957 it hardly seems reasonable to claim that the value of the Feuer had declined below its adjusted basis" (335 F.2d at 18), any claim for a depreciation deduction for 1957 could hardly be reasonable. But reliance on this sentence is plainly misplaced, and, as stated by the Tax Court in *Macabe Co., Inc.* v. *Commissioner,* 42 T.C. 1105, 1114, this is "reading too much" into that one sentence.

The sentence referred to is contained in a general introductory paragraph to a section of the regulations which describes the various "Methods of computing depreciation". It follows immediately after a sentence

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best available data on probable market conditions and demand for those particular types of vehicles at those intervals of time."

"The American Automotive Leasing Association believes that it has provided its membership with the best possible tools for arriving at reasonable depreciation allowances when new fleets of vehicles are put into service. And, as prudent business men, the members exert every effort to make their estimates of useful life and salvage value as close to the subsequent facts as possible, in order to obtain the return of their capital outlay. But we respectfully suggest that if unforeseen conditions arise,—such as war, national emergencies, material shortages, periods of inflation, or large business upturns, etc.,— resulting in larger salvage recoveries than could reasonably have been anticipated, then the resulting gains on disposition may properly be retained and reported as capital gains, * * *."

which provides that, regardless of the method used in computing depreciation, deductions shall not exceed the amount necessary to recover the cost of the asset less its estimated salvage value "during the remaining useful life of the property," and it is followed by a sentence stating that claimed depreciation deductions will be changed "only where there is a clear and convincing basis for a change." There then follow, in other paragraphs, detailed descriptions and examples of the various methods of depreciation permissible under section 167 of the Internal Revenue Code.

It seems plain that the sentence relied on is merely part of a general section introducing the various reasonable methods of computing depreciation for *continued use* of depreciable property during its "remaining useful life." It does not purport to deal with the disposition of assets. In this regard, the sentence is no different from the provisions of sections 1.167(a)-1(b) and (c), already referred to, which provide for the modification of "estimated remaining useful life" on the basis of conditions known to exist at the end of a tax year, and for a modification of the salvage value estimate, based upon facts known at the time of such redetermination of the estimate of useful life. See *supra*, pp. 19 to 21.[14] It certainly is not a provision

[14] Even if this one sentence were construed to be applicable to the year of disposition, the limiting provisions of sections 1.167(a)-1(b) and (c) (see *supra* p. 21, n. 12) would still be applicable, and the mere fact that recovery on resale may have exceeded the estimated salvage would not permit or require a change in the estimate, as the Commissioner has done here, because, if the plan were reasonable, as is conceded, the excess could only have arisen because of a change in price levels. Furthermore, section 1.167(b)-(O)(a), just like section 1.167(a)-1(b), requires that the reasons for a change be "clear and convincing".

which requires the automatic disallowance of depreciation in the year of sale whenever a gain, however small, is reported. The consequences attendant upon the disposition of an asset are, as already noted, specifically set forth in another section (1.167(a)-8(a)(1)); and, where a gain is reported, that gain is not eliminated by the adjustment of depreciation, but rather it is subjected to tax under section 1231 of the Internal Revenue Code. The claimed meaning of this one sentence of section 1.167(b)-(O)(a) is so completely inconsistent with all the other provisions of the regulations that it must be rejected. See *United States* v. *S & A Company,* 338 F.2d 629, 641 (C.A. 8), pending on petition for a writ of certiorari, No. 50, this Term; *Macabe Company, Inc.* v. *Commissioner,* 42 T.C. 1105, 1114. *Wyoming Builders, Inc.* v. *United States,* 227 F.Supp. 534, 536 (D. Wyo. 1964) pending on appeal to the Tenth Circuit. Moreover, as District Judge Blumenfeld stated in *Motorlease Corporation* v. *United States,* 215 F.Supp. 356, 361, "Even if, as the commissioner urges, 'The reasonableness of any claim for depreciation shall be determined upon the basis of conditions known to exist at the end of the period for which the return is made', it does not automatically follow that a price received upon the sale of a depreciable automobile, somewhat greater than estimated when it was acquired fourteen months before, established that the estimate and the depreciation based upon it was unreasonable. To illustrate: in four specific instances in this case the Commissioner disallowed depreciation respectively of \$0.03, \$2.82, \$2.33 and \$4.70. The regulations do not operate to automatically convert * * * an amount estimated at the time of acquisition to the amount realised upon sale. They do not require hindsight revisions."

It is plain from the foregoing provisions of the depreciation regulations, we submit, that a reasonable plan of depreciation for an asset is not to be disturbed and discarded after the disposal of the asset simply because the selling price exceeded its adjusted basis. The regulations make crystal clear, in our view, that salvage value is not selling price and that useful life is not the actual period of use in a taxpayer's business. The depreciation allowance is statutorily defined as a "reasonable allowance"; it is based on reasonable estimates; and it is not a single fixed amount based on cost less selling price, with regular adjustments automatically required every time an asset is disposed of for more than its adjusted base, designed to equate the period of estimate useful life with the period of actual use to the day, or to equate estimate salvage value with the precise amount to the penny recovered on disposition of an asset.[15]

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[15] In his opinion in *The Motorlease Corporation* v. *United States*, 215 F.Supp. 356, 358-359, District Judge Blumenfeld refers to several additions to the regulations which appeared for the first time in the final regulations (21 F.R. 3985) and which were not present in earlier published proposals. (19 F.R. 6229, 20 F.R. 8454). These additions made clear that salvage value was an estimated amount and not resale price, and further provided specifically for the capital gains treatment of gains realized upon the sale of a depreciable asset. Judge Blumenfeld found these additions significant. With respect to the definition of "salvage value" he stated: "It would be hard to find more explicit evidence of the Treasury's opinion that salvage value must be estimated as of the time of acquisition of a depreciable asset than is revealed by these extensive additions to the originally proposed regulations which are found in it when finally adopted." 215 F.Supp. at 358. And with respect to the capital gains provisions, he stated: "There is merit to the taxpayer's argument that this constitutes an implicit recognition by the Treasury of the settled administrative practice, that where the taxpayer honestly and reasonably complies

These views as to the meaning of the regulations are no different from those expressed by the Commis-

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with the regulations, the actual sales price, may, nevertheless, yield some gain or loss which remains to be accounted for at the rates applicable to an exchange transaction." 215 F.Supp. at 359. The Tax Court has also made reference to the changes made in the regulations during the course of their adoption. *Macabe Company, Inc.* v. *Commissioner,* 42 T.C. 1105, 1112, n.12. See also *S &A Company* v. *United States,* 218 F.Supp. 677, 683 (W.Minn.).

In this connection, it is interesting to note that when the proposed depreciation regulations were published for the second time in the Federal Register as proposals (20 F.R. 8454), the American Automotive Leasing Association, in a letter to the Commissioner, dated December 10, 1955, submitted an analysis of the proposals in which it was pointed out that, under the regulations as then proposed, salvage value might be equated with the actual price recovered on the sale of an asset, with the result that depreciation allowance would be required to be adjusted after the sale. It was urged that this was a radical departure from the accepted meaning of salvage value in the past, and suggestions were made for changes in the proposals so as to remove the possibility of the interpretation referred to and to make clear that the depreciation allowance was to be based on estimates of salvage value and useful life and was not to be disturbed, if reasonable. A copy of the letter is set forth in Appendix B, *infra,* pp. 7a to 15a.

In his reply brief in the court below in the *Motorlease* case, the Commissioner asserts (p.6) that the Association letter raised objections only to *retroactive* adjustments of deductions for prior years, and that no special concern was expressed about adjustments in the year of sale. The Commissioner's point is not well-taken. It is clear that what was meant by a retroactive adjustment was an adjustment after the sale and not merely for years prior to the year of sale. Further, there was no need to single out the year of sale as a matter of special concern, because the decision in *Wier Long Leaf Lumber Co.,* 9 T.C. 990, holding that depreciation during the year of sale was not limited by the price received for automobiles used in a business, had been acquiesced in by the Commissioner. 1948—1 C.B.3. This acquiescence was not withdrawn until after this litigation was underway. 1962—1 C.B.5.

sioner to this Court in *Massey Motors, Inc.* v. *United States* and *Commissioner* v. *Evans*, 364 U.S. 92. In his brief in *Evans* (No. 143, October Term, 1959) the Commissioner stated (pp. 10-11): "Concededly, if taxpayer, after holding a car for a period of time and employing it in the rental business, sells that car at a gain, the gain is entitled to treatment as a capital gain." As to the limit of the total deductions for depreciation, the Commissioner stated further (p. 29):

> On the other hand, if, as the Commissioner contends, the depreciation deduction must be based upon a rate determined by the period during which the asset can reasonably be expected to be used in the taxpayer's business and a reasonable estimate of salvage value at the end of that period, *there will be no conversion of ordinary income into capital gain. Ordinary and predictable salvage value, determined as of the time that sale of the asset is contemplated, will impose a realistic ceiling upon depreciation claims.* (Italics supplied)

B. The Commissioner's Action Is in Conflict with the Principles Affirmed in the Massey Motors and Evans cases, 364 U.S. 92.

The specific question involved in the *Massey Motors* and *Evans* cases was whether, for the purpose of determining the reasonable allowance for depreciation, the useful life of a depreciable asset is the total period of physical or economic life inherent in the asset, or the period of its estimated use in the particular taxpayer's business. In concluding that the latter period was the appropriate measure, the Court stated that a taxpayer must "estimate the period the asset will be held in the business and the price that will be received for it on retirement. Of course, there is a risk of error in such

projections, but prediction is the very essence of depreciation accounting". 364 U.S. at 105.

The Court was not unaware of the fact that, upon sale of a depreciable asset, gains realized "are capital gains and incur no more than a 25% tax rate" (*Id* at 97), and it recognized that its definition of useful life would not eliminate the realization of capital gains. Its definition, the Court noted, merely represented an approach which was "far *more likely to reflect* correctly the actual cost over the years in which the asset is employed in the business." *Id* at 106 (Italics supplied.)[16]

Indeed, in the *Evans* case, the Commissioner, in disallowing the taxpayer's claimed depreciation deductions for the reason that no proper and reasonable estimates of useful life and salvage value had been made, did not undertake to equate estimated salvage value with actual sales price; nor did he disallow depreciation in the year of sale as such. Instead, he, himself, made the estimates which the taxpayer should have made in the first place; and, at a time when the vehicles in that case had already been sold for an average price of $1380.00, he estimated their reasonable salvage value at $1325.00 and allowed depreciation during the year of sale down to that estimated figure which

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[16] The Court concluded that "the Congress intended that the taxpayer should, under the allowance for depreciation, recover only the cost of the asset less the *estimated* salvage, resale or second-hand value. This requires that the useful life of the asset be *related* to the period for which it may *reasonably* be expected to be employed in the taxpayer's business. Likewise, salvage value must include *estimated* resale or second-hand value". *Id.* at 107. (Italics Supplied).

was below the actual sales price, thereby permitting an average capital gain of $55.00 per vehicle.[17]

In the *Massey Motors* case, many of the vehicles involved were disposed of during the same year in which they were purchased (see Brief for the United States, No. 141, Oct. Term, 1959, pp. 4-5, fn. 2); yet the Government made no contention or suggestion that, in any event, as to those vehicles, the depreciation should be disallowed on the theory it now puts forward. The depreciation had been disallowed by the Commissioner on the ground that the vehicles were not property used in the trade or business, but were held primarily for sale to customers in the ordinary course of the taxpayer's trade or business. *Ibid.* And when the taxpayer filed a refund suit in the District Court and obtained a ruling that its vehicles were capital assets entitled to depreciation and that its inherent life theory of useful life was proper (*Massey Motors, Inc.* v. *United States,* 156 F.Supp. 516 (S.D. Fla. 1957), the Government, in the Court of Appeals, abandoned its contention that the vehicles were ordinary stock in trade and relied solely on the contention that useful life is the estimated period of use in the particular taxpayer's business and that depreciation cannot prop-

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[17] District Judge Blumenfeld in the *Motorlease* case observed (215 F.Supp. 356, 360-361): "Indeed, it is clear that the commissioner did not even argue in *Massey* for the proposal he asserts here. In calculating the taxpayer's deficiencies, he used an estimated salvage value of $1325.00 per car, rather than $1380.00, which was the actual selling price. He was not trying to eliminate all interplay between §167 and §1231". See also Circuit Judge Moore, dissenting in *Fribourg Navigation Co.* v. *Commissioner*, 335 F.2d 15, 21; *United States* v. *S & A Co.*, 338 F.2d 629, 642 (C.A. 8), now pending on petition for writ of certiorari, No. 50, this Term.

erly be determined without estimating salvage value as of the end of that estimated useful life. Brief for the United States, *supra,* pp. 5-6; *United States* v. *Massey Motors, Inc.,* 264 F.2d 552, 554 (C.A. 5).

In the Government's briefs to this Court in *Evans* and *Massey Motors,* the Commissioner properly argued that the reasonable allowance for depreciation was not intended to be a device to convert ordinary income into capital gains, and, as we have already noted, the Commissioner urged that the adoption of his definitions of useful life and salvage value, with which we agree and which have been followed by the taxpayers in this case as well as in *Motorlease,* would not result in such an improper conversion of ordinary income into capital gain since "Ordinary and predictable salvage value, determined as of the time that sale of the asset is contemplated, will impose a realistic ceiling upon depreciation claims". (*Supra,* p. 28).

Nowhere in the Commissioner's briefs in *Massey Motors* or *Evans* is there a single reference to any principle that would disallow depreciation in the year of sale when a gain is reported. The decision in *Cohn* v. *United States,* 259 F.2d 371 (C.A. 6), which apparently is relied on for the principle,[18] had been decided long before the Government's briefs were filed in *Massey Motors* and *Evans,* yet at no place in the Government's briefs is there any reliance or even reference to the *Cohn* case for the proposition now being

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[18] See Rev. Rul. 62-92, (1962-1 Cum.Bull.29).

urged here; and the *Cohn* decision is not even cited in this Court's opinion.[19]

We have no criticism of the Commissioner's contentions or arguments in *Massey Motors* and *Evans;* we are in complete agreement with them. The point is that this Court's opinion must be read in the context of the arguments that were presented to it, and, in that context, what was approved by this Court in those cases was precisely what the court below in both the *Fribourg Navigation Co.* and *Motorlease* cases disapproved. To be sure, this Court in *Massey Motors* and *Evans* did not have before it the single isolated issue of year-of-sale depreciation as is involved here; but the broader issues before the Court in *Massey Motors* and *Evans* necessarily included the narrower one involved here, and the opinion of the Court on the broader issue concerning the nature of the reasonable allowance for depreciation and the accounting therefor has affirmed principles which, we submit, are completely at odds with a general rule of law requiring an automatic disallowance of depreciation in the year of sale

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[19] In a companion case, *The Hertz Corp.* v. *United States*, 364 U.S. 122, the Government's brief (No. 283, Oct. Term. 1959, p.32 n.6 and p.40) quotes from *Cohn* only for the general proposition that depreciation must be based upon reasonable estimates of useful life in the business and of salvage value as of that time, and on page 50, n.27 it describes the holding thus: "It (the court) required that the taxpayers, who had reasonable notice that their assets had relatively high salvage value, adjust their depreciation deductions in the last years of useful life to take account of that factor. Taxpayers in that case had not deducted any salvage value in the first instance (though they were operating under the straight line method) and the court appropriately held that no further depreciation deductions were allowable after the assets had been depreciated down to reasonable salvage value."

geared to selling price, as opposed to reasonably estimated salvage value.

Neither panel of the court below, either in this case or in the *Motorlease* case, saw fit even to mention this Court's decision, let alone to discuss or analyze it. Instead, the court was of the opinion "that the Cohn case adequately supports the Commissioner's position", "though it could have been more explicit", 335 F.2d at 17. Circuit Judge Moore, on the other hand, in his dissent below, found support for the taxpayers in this Court's decision in *Massey Motors* and *Evans*, and he referred to the District Court's opinion in *Motorlease*, 215 F.Supp. 356 (D. Conn. 1963), as a "thorough and well reasoned analysis of the depreciation problem", 335 F.2d at 15. District Judge Blumenfeld, of course, relied heavily upon *Massey Motors* and *Evans* for his conclusions. See 215 F.Supp. at 359-361.[20]

Other courts have relied on *Massey Motors* and *Evans* in rejecting the Commissioner's general rule of law, which requires the disallowance of depreciation in the year of sale in every case where an asset is sold at a gain. *United States* v. *S & A Company,* 338 F.2d 629, 634, 640-641 (C.A. 8), now pending on petition for writ of certiorari, No. 50, this Term; *S & A Company*

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[20] Circuit Judge Moore, dissenting in *Fribourg Navigation,* expressed the view that, in any event, the *Motorlease* case was wrongly decided by the other panel of the court. "Motorlease as decided by this court in substance and actuality goes contrary to the decisions of the Supreme Court in Massey and Evans". * * * Motorlease was analagous to, and should have been controlled by, Massey, Evans, and Hertz. Yet there is no consideration of, or even mention of, those important cases or the legal principles declared therein". 335 F.2d at 21.

v. *United States,* 218 F.Supp. 677, 680, 682 (D. Minn. 1963); *Macabe Company, Inc. et al* v. *Commissioner* 42 T.C. 1105, 1112-1115; *Holder Drive-Ur-Self, Inc.* v. *Commissioner,* 43 T.C. 202, 208; see *Wyoming Builders, Inc.* v. *United States,* 227 F.Supp. 534, 538 (D. Wyo. 1964), pending on appeal to the Tenth Circuit; *Occidental Loan Company* v. *United States,* 235 F. Supp. 519, 524-525 (S.D. Cal. 1964).

In any event, the Commissioner's rule has not met with success in the courts. Apart from the decisions of the panels of the court below in this case and in the *Motorlease* case, and a decision of the United States District Court for the Eastern District of Tennessee (*Killebrew* v. *United States,* 14 AFTR 2d 5545 (E.D. Tenn. 1964), every court which has now specifically considered the Commissioner's contention has rejected it. *United States* v. *S & A Company,* 338 F.2d 629 (C.A. 8), now pending on petition for writ of certiorari, No. 50, This Term; *S & A Company* v. *United States,* 218 F.Supp. 677 (D. Minn. 1963); *Wyoming Builders, Inc.* v. *United States,* 227 F.Supp. 534 (D. Wyo. 1964), pending on appeal to the Tenth Circuit; *The Motorlease Corp.* v. *United States,* 215 F.Supp. 356 (D. Conn. 1963); *Occidental Loan Co.* v. *United States,* 235 F.Supp. 519 (S.D. Cal. 1964); *Kimball Gas Products Co.* v. *United States,* 63-2 U.S.T.C. Par. 9507 (W.D. Tex. 1962), pending on appeal to the Fifth Circuit; *Macabe Company, Inc.* v. *Commissioner,* 42 T.C. 1105; *C. L. Nichols et al* v. *Commissioner,* 43 T.C. 135; *Harry Trotz* v. *Commissioner,* 43 T.C. 127; *Moses Lake Homes, Inc.* v. *Commissioner,* T.C. Memo, 1964-289; *Palmaneda Adams* v. *Commissioner,* T.C. Memo, 1964-286; *Holder Driv-Ur-Self, Inc.* v. *Commissioner,* 43 T.C. 202; *Harry Friend* v. *Commissioner,* T.C.

Memo, 1965-35; cf. *Melvon Miller* v. *Commissioner,* T.C. Memo, 1964-305; *Smith Leasing Co.* v. *Commissioner,* 43 T.C. 37; *Bell Lines, Inc.* v. *Commissioner,* 43 T.C. 358; *The Covered Wagons, Inc.* v. *Commissioner,* T.C. Memo, 1965-79. See also *Forrester Box Co.* v. *Commissioner,* 123 F.2d 225, 229 (C.A. 8).

Indeed, after its decision in favor of the Commissioner in this very case had been affirmed by the court below, the Tax Court, in the *Macabe* case, *supra,* refused nevertheless to follow the decision of the court below, stating specifically that it disagreed with its rationale (42 T.C. at 1110),[21] and the Tax Court, in all subsequent decisions, has rejected the Commissioner's contention for a general rule of disallowance of depreciation in the year of sale at a gain. See cases cited *supra,* pp. 34-35.[22]

The decision of the Sixth Circuit in *Cohn* v. *United States,* 259 F.2d 371 (C.A. 6), which the Commissioner has relied on so heavily in support of his rule (see e.g. Rev. Rul. 62-92, 1962-1 Cum. Bull. 29) and which the court below thought "adequately supports the Commissioner's position" (335 F.2d at 17), has not persuaded the other courts. It has either been distinguished on its facts, or it has been criticized as wrong-

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[21] The Tax Court stated, however, that it agreed with the *results* reached in the two cases below. We respectfully submit that the Tax Court's agreement with the results was based upon an apparent misunderstanding of the facts in the case. As to *Motorlease,* the details are set forth in footnote 24, p. 19 of the petition for a writ of certiorari in that case (No. 24, This Term), to which the Court is respectfully referred.

[22] Cf. the earlier Tax Court decision in *Rouse* v. *Commissioner,* 29 T.C. 70, which was, in effect, overruled by *Macabe,* 42 T.C. at 1116.

ly decided. See cases cited *supra*, pp. 33-35. And the writers have accorded the *Cohn* decision and the year-of-sale disallowance rule the same treatment as the courts. See Comment, *Disallowance of Depreciation in Year of Sale,* 50 Va. L. Rev. 1431; Note, 41 Ore. L. Rev. 159; Note 49 Cornell L.Q. 325; Note, VI Boston College Industrial and Commercial L.Rev. 631; Comment, 67 W.Va. L.Rev. 166; Note 33 Fordham L.Rev. 525; Note, 53 Georgetown L.J. 831; Horvitz, *Although CA2 upholds IRS on year-of-sale depreciation, Cohn rule may help taxpayers,* 21 Jour. of Taxation 203; Merritt, *Government Briefs in Cohn refute IRS disallowance of year-of-sale depreciation,* 20 Jour. of Taxation 156; Horvitz, *Sections 1250 and 1245: The Puddle and the Lake,* 20 Tax L. Rev. 285; 3 Rabkin and Johnson, *Federal Income, Gift and Estate Taxation,* § 43.14, p. 4397m; see also Smith, *Problems in the Disposal of Rental Property,* 13 Tax L.Rev. 331, 331-341; Walther, *Depreciation in the Year of Sale: Recent Developments,* 51 A.B.A.J. 281.

There is, thus, no support for the Commissioner's rule and the holding of the court below, either on principle or authority. The Commissioner having conceded the reasonableness of all of the factors making up the reasonable allowance for depreciation, it is plain then that there has been no conversion of ordinary income into capital gain by excessive depreciation allowances in either this case or the *Motorlease* case. The excess of the sales price of the assets over their adjusted basis reflects gains in value to be accounted for as such and taxed as such.

C. The Commissioner's Action Conflicts With Basic Accounting Principles.

We have argued above that if a taxpayer establishes a reasonable plan of depreciation for an asset used in the business, based on reasonable estimates of useful life and salvage value, as provided for in section 167 of the Internal Revenue Code of 1954 and the Commissioner's regulation thereunder, he is authorized, by the statute and regulations, to continue to take a depreciation deduction for such asset until the asset is disposed of or is no longer useful in the business, so long as the adjusted basis of the asset does not go below the estimated salvage value. And we have argued that the statute and regulations, properly construed, do not authorize the Commissioner to disallow a depreciation deduction, otherwise allowable for such asset during the year in which it is sold, merely because it was sold for more than its adjusted basis or book value.

This view of the statute and regulations does not establish new doctrine or new principles; it merely represents well-settled and long-established basic principles of depreciation accounting. And we shall show that the Commissioner's arbitrary rule is in conflict with these principles.

The accounting principles are clear. "Accounting for financial management and accounting for federal income tax purposes both focus on the need for an accurate determination of the net income from operations of a given business for a fiscal period". *Massey Motors, Inc.* v. *United States,* 364 U.S. 92, 106. In determining periodic net income, the costs involved in producing the income must be taken into consideration (*United States* v. *Ludey,* 274 U.S. 295, 304), and among those costs is the cost of the use of capital assets

devoted to the business. *United States* v. *S & A Company,* 338 F.2d 629, 639-640 (C.A. 8). It is the purpose of depreciation accounting, as we have already noted, "to make a meaningful allocation of this cost to the tax periods benefited by the use of the asset." (*Massey Motors, Inc.* v. *United States,* 364 U.S. 92, 96), "to distribute equitably throughout the several years of service life * * * the known cost less the estimated salvage value" (Mr. Justice Brandeis, dissenting in *United Railways & Electric Co.* v. *West,* 280 U.S. 234, 264).

Although the depreciation allowance has been defined in a variety of terms by the writers, "In all of these statements the essential conception is that of assigning the cost of the property to the accounting periods included in the useful life" (Paton, *Accountant's Handbook,* (3rd ed. 1947), p. 711),[23] and it is accepted

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[23] Some of the definitions of depreciation set forth in Paton, *supra,* p. 711, follow: "According to Montgomery (Auditing Theory and Practice) depreciation is 'an allocation of the entire cost of depreciable assets to the operating expenses of a series of fiscal periods'. Mason, (Principles of Public Utility Depreciation, American Accounting Association) states that 'depreciation is the expiration or disappearance of capital investment from the time of putting the asset into use until the time of its retirement from service'. J. B. Bailey (Journal of Accountancy, vol. 74) describes depreciation as 'the accounting for the consumption of the wasting of invested capital'."

See also the definition of depreciation by The Committee on Terminology of the American Institute of Certified Accountants, set forth in *Accountant's Encyclopedia,* (Prentice Hall, 1962) v.1, pp. 175-176: "*Depreciation* accounting is a system of accounting that aims to distribute the cost or other basic value of tangible capital assets over the estimated useful life of the unit * * * in a systematic and rational manner. It is a process of allocation, not valuation. Depreciation for the year is the portion of the

accounting practice to allocate the cost less the estimated salvage value of an asset over the entire period[24] of its estimated useful life in the taxpayer's business. In his 1923 edition of *Depreciation Principles and Applications,* Saliers wrote (p. 232): "If, as is not unlikely to be the case, an error is made in estimating the proper rate to be used owing to the impossibility of forecasting with great accuracy the useful life of an asset, it will be found that, when the property is abandoned or scrapped, the sum written off plus salvage value will not equal original cost. If too little has been written off the difference should be taken as a loss in the year in which the property is scrapped and should be deducted in that year for income tax purposes. If too much has been written off the excess should be reported as income in the year in which the residual value of the property is realized. This is equivalent to the realization of a larger salvage value than was anticipated." The fact that the market value of an asset may have appreciated during the period of its use

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total charge under such a system that is allocated to the year. The concept that depreciation is an allocation of the cost of an asset over its service life is an application of the principle of matching costs against revenues. Each period that obtains the beneficial use of an asset is charged with an equitable share of its total cost less salvage value." See also Grant and Norton, *Depreciation* (1955) p. 34; Reynolds, *An Analysis of Depreciation Methods and Bases* (School of Business Administration, Univ. of North Carolina, 1962.)

[24] Saliers, *Depreciation Principles and Applications* (3rd ed. 1939) p. 160 (The "factors necessary to the composition of the current accounting period's depreciation charge are (a) original cost, (b) estimated life, and (c) estimated salvage value."); Finney and Mitter, *Principles of Accounting, Intermediate,* (5th ed. 1960) p. 335. See Note, 67 W.Va. L.Rev. 166, Note, 41 Ore. L.Rev. 159, 168.

resulting in a gain on the disposition of an asset does not, as a matter of accounting practice, exclude the year of sale from the period of use for which depreciation is allowable. Accountant's Encyclopedia, *supra,* vol. 1, pp. 175-176; Finney and Mitter, *supra,* p. 355; Saliers, *supra* (1939 ed) p. 100; Saliers, *supra* (1923 ed), pp. 50, 233; Grant and Norton, *Depreciation* (1955) pp. 34, 38. Indeed to consider market appreciation in value as offsetting depreciation is deemed an "impropriety" as a matter of accounting practice, Paton, *supra,* pp. 717, 718, 780.[25]

These well settled accounting principles were incorporated into the earliest published decisions of the Board of Tax Appeals over forty years ago which held that a depreciation deduction for property used in the taxpayer's business should be taken until the time the property was sold in order to arrive at the basis of the property for the purpose of determining the gain on disposition.[26] There was not the slightest suggestion that a depreciation deduction could not be taken in the year of sale if to do so would reduce the adjusted basis below the selling price. Indeed, it was the Commis-

[25] "The gains and losses on disposal are, in some degree, a correction of prior-period depreciation. However, since the element cannot be isolated, the full difference between the disposal price and book value is treated as a gain or loss for the period of retirement". Accountant's Encyclopedia, *supra,* vol. 1, p. 188.

[26] See e.g., *Even Realty Co.,* 1 B.T.A. 355; *W. W. Carter,* 1 B.T.A. 849; *Grosvenor Atterbury,* 1 B.T.A. 169; *Star Sporting Goods Co.,* 1 B.T.A. 1266; *Keighly Manufacturing Co.,* 2 B.T.A. 10; *Marchetta Roma Cafe Co.,* 2 B.T.A. 529; *Walter Frank,* 2 B.T.A. 905; *Cotton Concentration Co.,* 4 B.T.A. 121; *Capital City Investment Co.,* 4 B.T.A. 933; see *Union Metal Manufacturing Co.,* 1 B.T.A. 395, 398.

sioner who pressed the position that depreciation must be taken to the date of sale in order to establish the true gain realized on the sale of the asset.[27] And, in 1927, in *United States* v. *Ludey,* 274 U.S. 295, this Court held that in determining the gain realized on the sale of depreciable property, depreciation must be deducted to the date of the sale and the basis of the property adjusted accordingly. See also *Rieck* v. *Heiner,* 25 F.2d 453, 454 (C.A. 3), cert. den. 277 U.S. 608; *Forrester Box Co.* v. *Commissioner,* 123 F.2d 225, 229 (C.A. 8). "This accounting system has had the approval of this Court since *United States* v. *Ludey.*"

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[27] In *Even Realty Co.,* 1 B.T.A. 355, the Board of Tax Appeals stated (pp. 361-362): "There is no reason why wear and tear, purely intrinsic matters, need be tied up to appreciation resulting from extrinsic causes. The two can go on simultaneously and no provision of law requires one to be offset against the other. The revenue acts do not contemplate the annual computation of appreciation for the purpose of taxing the increase of value thereby—they expect appreciation to be accounted for at the final disposition of the property. * * * Machinery and buildings do not gain in value, like cheese or wine, merely through lapse of time, nor do they improve with use." Compare this statement with the recent statement of the Tax Court in *Macabe Company, Inc.* v. *United States,* 42 T.C. 1105, 1109: "We find merit in petitioner's argument that the granting of a reasonable allowance for depreciation is a matter separate and distinct from the computation of gain upon the sale of property formerly held in the taxpayer's trade or business or for the production of income. The concepts of depreciation through the process of exhaustion, on the one hand, and of appreciation or depreciation because of market conditions, on the other hand, are mutually exclusive."

Massey Motors, Inc. v. *United States,* 364 U.S. 92, 104.[28]

The Commissioner attempts to discount these early decisions by asserting that the Commissioner has the right to change his interpretation where he believes it warranted, Cf. *Automobile Club of Michigan* v. *Commissioner,* 353 U.S. 180. This may be so. But we refer to these early cases, not as binding precedents on the precise issue here involved, but as representing the long-existing and common understanding of the nature of the depreciation allowance and its relationship to the gain realized on the sale of a depreciable asset, and it is apparent that the Commissioner's arbitrary general rule of excluding depreciation in the year of sale at a gain is in the teeth of the accepted and long-established principles of depreciation accounting. Cf. *Duncan-Homer Realty Co.,* 6 B.T.A. 730.

The Commissioner's theory arbitrarily excludes the last year of use of an asset from the period of depreciation despite the fact that the asset is concededly in use during that year in the taxpayer's business, and notwithstanding that during that year it contributes to the receipt of income and its use constitutes a legitimate cost incurred in the production of income just as

[28] The opinion in *United States* v. *S & A Company,* 338 F.2d 629, 636-637, (C.A. 8) refers to additional cases allowing depreciation during the year of favorable sale and to "a series of administrative procurements in which depreciation to the date of sale seems consistently to have been recognized." Cf. *Thomas Goggan & Bro.,* 45 B.T.A. 218, where the Board of Tax Appeals refused to allow additional depreciation during the year in which an asset was traded and the trade-in allowance was less than the depreciated basis, on the ground that the trade-in allowance could not determine the amount or rate of depreciation to be allowed.

in the years prior to the year of sale. Not only does this violate the basic principle that depreciation accounting is intended to make a meaningful allocation of the cost of the use of an asset to all of the periods to which it contributes, but it violates the Commissioner's own regulation, as already noted, requiring that "the period for depreciation of an asset shall begin when an asset is placed in service and shall end when the asset is retired from service". Section 1.167(a)-10(b). Further, the Commissioner's position that the "depreciation disallowance should be limited to the year in which an asset is sold for more than its adjusted basis" (*Fribourg Navigation Co.* v. *Commissioner,* 335 F.2d 15, 16, 20) has the double effect of overstating income for the year of sale and understating income during prior years—a distortion that conflicts with proper accounting practices and which results solely from the Commissioner's attempt to equate a known sales price with estimated salvage value.[29]

The Commissioner's position would have the effect of making the accounting for depreciation depend upon wholly artificial and unrealistic circumstances,

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[29] Reference to the accelerated depreciation provisions of section 167(b) and 167(e) of the Internal Revenue Code does not support the Commissioner's theory. To be sure, they authorize larger depreciation deductions in the earlier years of an asset's use. But even under those provisions, the limit of the depreciation allowance is the estimate of "reasonable salvage value" and not the resale price (Section 1.167(a)-1(a)). Moreover, and in any event, the extent to which the earlier years of an asset's use may permissibly bear a higher deduction for depreciation than the later years is authorized by the specific statutory provisions enacted for economic purposes to encourage investment in plant and equipment by permitting a speedier return of capital outlay than would normally be permissible.

and, indeed, would create such a preoccupation with tax consequences as to invite wholly abnormal business practices. For example, a taxpayer can avoid the effect of the Commissioner's rule by holding an asset until a few days after the close of his tax year and then selling it. This is so, because, as already noted, under the Commissioner's position, depreciation is not disturbed for the years prior to the year of sale. In this case and in the *Motorlease* case, every penny of disallowed depreciation could, on the Commissioner's theory, legitimately have been retained by the taxpayers if the assets had been held until a few days into new tax years and then sold. In the *Fribourg* case, the taxpayer disposed of the vessel on December 23, 1957, and the Commissioner disallowed all depreciation claimed during all of 1957. If the vessel had been held for a very short period more, until a few days into January of 1958, apparently, under the Commissioner's theory, depreciation for the entire year of 1957 would have been permissible and allowed.

We suggest that it is absurd to assert, on the one hand, that the vessel had declined in value for depreciation purposes in 1957 because it was not sold until a few days into 1958, and to assert, on the other hand, that it had not declined at all in value for depreciation purposes in 1957 because it was sold a few days before the end of 1957. We suggest that it is absurd to assert, in one case, that the use of the vessel constituted a cost of doing business in 1957 and that, in other, its use did not represent a cost at all in 1957.[30] We sug-

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[30] The Commissioner's year-of-sale theory has implicit in it the notion of *scienter*—a taxpayer is not entitled to a deduction when he *knows* that the asset has not diminished in value, which is the situation, in the Commissioner's view, only after the sale.

gest, further, that it is absurd to assert that, in the one case, the use of the vessel contributed to the receipt of income in 1957 and that, in the other, the use of the vessel made no contribution at all to the receipt of income in 1957. And, finally, we suggest that the Commissioner's theory cannot "further the integrity of periodic income statements" (*Massey Motors Inc.* v. *United States,* 364 U.S. 92, 104) when the amount of income to be reported can be so readily altered by such artificial factors.

The Commissioner's theory invites abuse of the depreciation concept, and it penalizes the meticulously careful taxpayer.[31] Since capital gains developed in the years prior to the year of sale will not be affected under the Commissioner's theory, there is every incentive for a taxpayer to estimate salvage value as small as possible, within the area of reasonableness, thereby increasing the periodic depreciation deduction and reducing the adjusted basis of the asset in the years prior to the year of sale and creating the capital gain which the Commissioner concedes may be retained. A more strained and perverse interpretation of sound depreciation practice is difficult to imagine.

It seems quite clear to us why the Commissioner espouses a theory which involves such absurdities. If,

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But, if toward the end of a tax year, a taxpayer intended to dispose of an asset which had a large rise in value—as in this case—but did not actually sell it until early in the following year, it defies credulity to assert that the deduction in the year prior to the sale year was taken any less *knowingly* than in the year of sale.

[31] See 21 Journal of Taxation 203, 205: The Commissioner's rule "works most harshly against those taxpayers who are least guilty of over-depreciations. The rule works in favor of those who depreciate under a fast write-off method."

as the Commissioner argues, the taxpayer's estimates are no longer relevant after an asset is disposed of, and the actual selling price is to determine the limit of the depreciation allowance, then the necessary logical conclusion is that *any* depreciation which reduces the basis below the selling price must be disallowed. This, of course, would result in the effective repeal of section 1231 of the Code and the Commissioner's own regulations providing for the tax treatment of gains on disposition as capital gains. In an effort to avoid being accused of administratively repealing section 1231, and in order to give some limited meaning and effect to that section, the Commissioner has, apparently, developed the notion of disallowing the deduction only during the year of sale, which is, we submit, a completely tortured view of the meaning of section 1231 and is without support either in the history of the statute or in the regulations providing for its administration.

We do not suggest that Commissioner must accept or allow all depreciation plans adopted by all taxpayers and that he is without authority to disallow excessive or unjustified claims based upon unreasonable estimates. We concede this authority in the Commissioner, and we contend that his proper functions and concern are with the reasonableness of the estimates and the resulting allowances. If, for example, the Commissioner is of the opinion that depreciation has been claimed in unrealistic amounts (cf. *Massey Motors, Inc.* v. *United States,* 364 U.S. 92) or on an unauthorized double-declining balance basis (cf. *Hertz Corp.* v. *United States,* 364 U.S. 122), he has ample authority to disallow them and insist that they be appropriately adjusted, and, under the Commissioner's

own regulations (section 1.167(b)-(O)(a), "it is the responsibility of the taxpayer to establish the reasonableness of the deduction for depreciation claimed." He is not limited to adjusting only the year-of-sale deduction. He is authorized, we contend, to disallow what he deems to be an unreasonable plan and require the adoption of a reasonable one, spread over the useful life of the asset in the taxpayer's business to the extent that the tax years are open, as the statute, the regulations, and sound accounting principles require. He cannot, however, arbitrarily disallow legitimate depreciation deductions during the final year solely because the asset was disposed of for more than its reasonably estimated salvage value.

We must emphasize that the burden on taxpayers to adopt reasonable depreciation plans is not a light one. It is not a simple matter to make a reasonable estimate in advance of what an asset will sell for when it is disposed of after use for an estimated period of time in a taxpayer's business. The normal difficulty is compounded for taxpayers like that in the *Motorlease* case who dispose of assets long before their value deteriorates to scrap. As we have already pointed out (*supra*, pp. 22-23, n. 13), the members of the American Automotive Leasing Association have incurred very large and substantial expenses in meeting the obligations which they believe the Commissioner's regulations put on them to make reasonable estimates. But the Commissioner, in total disregard of the obligation put on him to consider the reasonableness of a taxpayer's estimates, has adopted the arbitrary rule of automatic year-of-sale disallowance, casting aside the taxpayer's efforts as no longer relevant. This type of administrative response to a conscientious effort eliminates any

incentive upon the part of taxpayers to undertake the difficult and expensive and burdensome task of making really careful estimates in the first place. If the Commissioner's action represents proper practice, then the least informed guess is as good as a carefully considered estimate, just so long as too large a capital gain is not developed in years prior to the year of sale. We respectfully submit that both the taxpayer and the Commissioner have real obligations in the field of depreciation accounting and that the Commissioner cannot shirk his obligation by merely disregarding, as moot and irrelevant after the sale of an asset, what the taxpayer has carefully done in carrying out his obligation.

D. The Commissioner's Action Is Not In Accord With the Intent of the Congress.

We have shown, *supra*, p. 13, n. 5, that from the time of the enactment of the Special Corporate Excise Tax of August 5, 1909, 36 Stat. 113, the Congress has consistently defined the deduction for depreciation as a "reasonable allowance". And we have shown, further, *supra*, pp. 37 to 41, that, in the accounting for this "reasonable allowance" for depreciation, the year of sale was treated no differently than any other year and that it was well-accepted accounting practice, confirmed by the earliest decisions of Board of Tax Appeals and decisions of this Court, to take a depreciation deduction with respect to a depreciable asset for the entire period of its use up to the date of its sale, in order to determine the gain realized or loss sustained upon the sale of the asset.

In 1942, without in any way changing the definition of the reasonable allowance for depreciation contained

in section 23(l) of the Internal Revenue Code of 1939, and without any reference whatsoever to year-of-sale or actual selling price, the Congress added section 117(j) to the 1939 Code (Section 115(b) of the Revenue Act of 1942) which provided that gains realized upon the sale of depreciable assets used in the business for more than six months were to be taxable at capital gains rates only. This is now section 1231 of the Internal Revenue Code of 1954. As stated, there is nothing in this legislation or in its history to suggest, as the Commissioner now contends, that only the gains developed by depreciation deductions taken in the years prior to the year-of-sale were within the scope of the statute, that is to say, that no gain might be developed during the year of sale. The House Report, after noting that gains from the sale of depreciable property had been treated as ordinary income, stated (H.Rep. No. 2333, 77th Cong. 2d Sess. p. 15): "It appears that many taxpayers are able to dispose of their depreciable property at a gain over depreciated cost. To treat such gain as an ordinary gain will result in undue hardship to the taxpayer."

In 1947, the Treasury Department, in a report to the Congress commenting on a proposal to provide for accelerated depreciation, particularly for small business,[32] warned that accelerated depreciation allowances might enable a business man to convert ordinary income into capital gains by selling a fully depreciated asset that still had a substantial value and paying only a capital gains tax on the gain. This revenue loss could be avoided, the Treasury urged, by making the gain,

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[32] Hearings before the House Committee on Ways and Means, 80th Cong. 1st Sess, on Proposed Revisions of the Internal Revenue Code, Part V, p. 3756.

to the extent of the excess over normal depreciation, subject to tax as ordinary income. The proposal was not enacted, but, again, there was no suggestion that the Congress believed it was dealing only with those revenue losses that would result from gains that might be developed by depreciation deductions prior to the year of sale. On the contrary, it is quite clear that the Congress considered the problem in the light of revenue losses resulting from the sale of *fully depreciated* assets at a gain.

Likewise, in the course of its deliberations in connection with the development of the Revenue Act of 1950, the Congress again dealt with the capital gains provisions of section 117(j). Although the House Committee on Ways and Means proposed that *losses* on sales of section 117(j) property be treated as capital instead of ordinary losses (see H.Rep. No. 2319, 81st Cong., 1st Sess., p. 45), the Senate Finance Committee refused to go along with the suggestion (see S.Rep. No. 2375, 81st Cong. 2d Sess, pp. 51-52) and the proposal was rejected, as was the proposal to tax *gains* on the disposal of 117(j) assets as ordinary income. This latter proposal was rejected because it presented "serious difficulties" and would cancel out the beneficial results intended by the adoption of section 117(j) at a time when it was important that assets "get into the hands of those who will put them to most effective use". 96 Cong. Rec. 14057. The Congress, however, did enact in the Revenue Act of 1950 a provision for special five year amortization of certain certified national emergency facilities (section 216(a) of the Revenue Act of 1950, adding section 124A of the Internal Revenue Code of 1939) and amended section 117 to provide that any gains realized from the sale of

such facilities should be treated as ordinary income to the extent that deductions for such amortization exceeded the otherwise normally allowable depreciation deductions. Section 216(c) of the Revenue Act of 1950, adding sections 117(g)(3) of the Internal Revenue Code of 1939. In explaining how these provisions would operate, the Conference Report set forth examples disclosing clearly the Congressional understanding that depreciation not only could and should be taken to the date of sale in the year of sale, but also that such depreciation could create, in the year of sale, a gain to be taxed at capital gain rates, except to the extent that the special amortization deductions exceeded the otherwise normal depreciation deductions. See H. Rept No. 3124, 81st Cong., 2d Sess. p. 29.[33]

When the Revenue Act of 1951 was being considered by the Congress, it had before it a warning from the Treasury Department concerning a practice which had developed whereby a depreciable asset would be sold at a gain to a controlled corporation, the seller would pay only capital gains rates on the profits, and the buyer would have an increased basis for future depreciation deductions against ordinary income. H.Rep. No. 586, 82nd Cong., 1st Sess, p. 26. This abuse was corrected by the addition of a provision denying the capital gains treatment in connection with sales to various related taxpayers. Section 328(a) of the Revenue Act of 1951, adding sections 117(o) of the Internal Revenue Code of 1939. This was the only limitation engrafted upon the capital gain treatment of gains realized upon sale of depreciable assets, and there

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[33] See also these same examples which are still set forth in the Treasury Regulations, section 1.1238-1, Examples (1) and (2).

was no suggestion that gains were to be either eliminated or reduced by the disallowance of depreciation otherwise allowable during the year of sale.

In the Internal Revenue Code of 1954, the Congress provided for a variety of methods of accelerated depreciation (sections 167(b)(2), (3), (4)) and re-enacted section 117(j) of the 1939 Code without substantive change (Section 1231 of the Internal Revenue Code of 1954; see H.Rep. No. 1337, 83d Cong., 2d Sess, p. A275) even though it had before it recommendations to treat the gain on the sale of depreciable assets as ordinary income (Hearings Before Senate Committee on Finance, 83d Cong., 2d Sess, on H.R. 8300, p. 1324) and even though it was understood that the new methods would add to already existing tax advantages. 100 Cong. Rec. 3678.

In a letter to the Congress, dated April 20, 1961, on the federal tax system, the President recommended that the capital gains treatment be withdrawn from gains on the disposition of depreciable property, both personal and real. He stated as follows:

> This situation arises because the statutory rate of depreciation may not coincide with the actual decline in the value of the asset. *While the taxpayer holds the property,* depreciation is taken as a deduction from ordinary income. Upon its resale, where the amount of depreciation allowable exceeds the decline in the actual value of the asset so that a gain occurs, this gain under present law is taxed at the preferential capital gains rate. The advantages resulting from this practice have been increased by the liberalization of depreciation rates.[34] (Italics supplied)

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[34] Hearings before the House Committee on Ways and Means on the President's 1961 Tax Recommendations, H.Doc.No.140, 87th Cong. 1st Sess. v.1, p.13.

The Congress adopted the President's recommendation with respect to personal property by the addition in 1962 of a new section 1245 to the Internal Revenue Code of 1954, which treats as ordinary income the gain realized on the sale of depreciable personal property, during taxable years beginning after December 31, 1962, to the extent of depreciation taken after December 31, 1961. The House Report, in recommending enactment of the proposal, stated (H.Rep. No. 1447, 87th Cong. 2d Sess., pp. 66-67): "Wherever the depreciation deductions reduce the basis of the property faster than the actual decline in its value, then when it is sold there will be a gain. Under present law this gain is taxed as a capital gain, even though the deductions reduced ordinary income." See also S.Rep. 1881, 87th Cong., 2d Sess., p. 95. It would be difficult, we submit, to find a clearer statement of a Congressional understanding that actual resale price is not the limit of depreciation deductions, that such deductions may reduce the book value of an asset below its resale price, and that the gain resulting therefrom would be taxed at capital gains rates but for the addition of the new section 1245. Again, there was no indication whatsoever that what the Congress was concerned about was only the gains developed in the years prior to the year of sale of an asset or that depreciation, otherwise allowable, might not be allowable during the year of a profitable sale. Additionally, it must be emphasized that the provisions of section 1245 are not retroactive, and what the Commissioner here seeks to accomplish is to obtain a retroactive effect without statutory authorization.

Finally, by the addition in 1964 of section 1250 to the Internal Revenue Code of 1954, the Congress

removed the capital gains treatment with respect to real estate sold after December 31, 1963 to the extent of depreciation taken after that date if the property is held for one year or less,[35] or to the extent of the excess of such depreciation over straight line depreciation if the property is held for more than one year, but not more than 20 months, or to the extent of a percentage of such excess if the property is held for more than 20 months.[36]

We think that the course of the legislative activity, or inactivity, which we have just reviewed, discloses (1) that the Congress, until very recently, had no knowledge or information whatsoever of any doctrine or principle or decision requiring the disallowance of depreciation in the year of sale, (2) that, indeed, it had been warned time and again of revenue losses resulting from gains realized on the sale of depreciable assets, (3) that, on the basis of existing well-known principles

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[35] If the Commissioner's contention in this case were sound, or if the Congress had intended it to be the law, this provision would not have been necessary at all, because year-of-sale depreciation would not be allowable and there would be no capital gains to be taxed at any rate.

[36] In the Senate Report accompanying the bill which became the Revenue Act of 1954, adding said section 1250, the Senate Finance Committee referred—for the very first time, so far as we are aware—to a holding restricting a depreciation deduction in the year of sale. S.Rep. No. 830, 88th Cong. 2d Sess, p. 133. We think it most significant that during the entire period of time since the enactment of section 117(j) in 1942, this reference, in 1964, was the first reference, so far as we are aware, to the year-of-sale disallowance of depreciation, and the reference in the Senate report stated merely that "it has been held"; there is no statement of any established doctrine to that effect, or of any such accepted accounting principle.

and decisions, it believed that these revenue losses were the result of depreciation deductions which reduced the book value of an asset below its selling price and these included deductions taken during the year of sale, (4) that, notwithstanding all this, it refused, for many years, to amend the law at all, and (5) finally, when it did amend the law, it did so only gradually and on a piecemeal basis and without retroactive effect.

We think the Commissioner has attempted to accomplish by his ruling what the Congress had refused to do for so long a period of time. See *United States* v. *S & A Company*, 338 F.2d 629, 633 (C.A. 8); *The Motorlease Corp.* v. *United States*, 215 F.Supp. at 365-366; *Macabe Co., Inc.* v. *Commissioner*, 42 T.C. 1105, 1117-1118.[37]

[37] The Commissioner may urge that this course of legislative conduct is immaterial and irrelevant because his ruling deals merely with the deduction for the year of sale, whereas the Congress was dealing with the broader question of eliminating the capital gains treatment entirely. This contention is beside the point. Apart from the fact that the Commissioner's ruling goes a long way toward eliminating capital gains, the fact is that the Congress was dealing with the broader problem of depreciation deductions for any year—including the year of sale—creating capital gains. The broad area of concern of the Congress included the more narrow area of the present activity of the Commissioner, and the Congress failed or refused to act until only just recently.

CONCLUSION

For the foregoing reasons, therefore, it is respectfully submitted that the judgment of the court below should be reversed.[38]

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[38] We submit also that, on the basis of the foregoing, the Court should grant the petition for a writ of certiorari in the *Motorlease* case and reverse the decision of the court below in that case without hearing.

APPENDIX

APPENDIX A

Internal Revenue Code of 1954:

Sec. 167. Depreciation.

(a) *General Rule.*—There shall be allowed a depreciation deduction a reasonable allowance for the exhaustion, wear and tear (including a reasonable allowance for obsolescence)—

(1) of property used in the trade or business, or

(2) of property held for the production of income.

(b) *Use of Certain Methods and Rates.*—For taxable years ending after December 31, 1953, the term "reasonable allowance" as used in subsection (a) shall include (but shall not be limited to) an allowance computed in accordance with regulations presented by the Secretary or his delegate, under any of the following methods:

(1) the straight line method,

(2) the declining balance method, using a rate not exceeding twice the rate which would have been used had the annual allowance been computed under the method described in paragraph (1),

(3) the sum of the years-digits method, and

(4) any other consistent method productive of an annual allowance which, when added to all allowances for the period commencing with the taxpayer's use of the property and including the taxable year, does not, during the first two-thirds of the useful life of the property, exceed the total of such allowances which would have been used had such allowances been computed under the method described in paragraph (2).

Nothing in this subsection shall be construed to limit or reduce an allowance otherwise allowable under subsection (a).

(c) *Limitations on Use of Certain Methods and Rates.*—Paragraphs (2), (3), and (4) of subsection (b) shall apply only in the case of property (other than intangible property) described in subsection (a) with a useful life of 3 years or more—

* * * * *

(f) *Basis for Depreciation.*—The basis on which exhaustion, wear and tear and obsolescence are to be allowed in respect of any property shall be the adjusted basis provided in section 1011 for the purpose of determining the gain on the sale or other disposition of such property.

Treasury Regulations on Income Taxes (1954 Code):

Sec. 1.167(a)-1. *Depreciation in general.*—(a) *Reasonable allowance.* Section 167(a) provides that a reasonable allowance for the exhaustion, wear and tear, and obsolescence of property used in the trade or business of property held by the taxpayer for the production of income shall be allowed as a depreciation deduction. The allowance is that amount which should be set aside for the taxable year in accordance with a reasonably consistent plan (not necessarily at a uniform rate), so that the aggregate of the amounts set aside, plus the salvage value, will, at the end of the estimated useful life of the depreciable property, equal the cost or other basis of the property as provided in section 167(f) and § 1.167(f)-1. An asset shall not be depreciated below a reasonable salvage value under any method of computing depreciation. See paragraph (c) below for definition of salvage. The allowance shall not reflect amounts representing a mere reduction in market value.

(b) *Useful life.* For the purpose of section 167 the estimated useful life of an asset is not necessarily the useful life inherent in the asset but is the period over

which the asset may reasonably be expected to be useful to the taxpayer in his trade or business or in the production of his income. The period shall be determined by reference to his experience with similar property taking into account present conditions and probable future developments. Some of the factors to be considered in determining this period are (1) wear and tear and decay or decline from natural causes, (2) the normal progress of the art, economic changes, inventions, and current developments within the industry and the taxpayer's trade or business, (3) the climatic and other local conditions peculiar to the taxpayer's trade or business, and (4) the taxpayer's policy as to repairs, renewals, and replacements. Salvage value is not a factor for the purpose of determining useful life. If the taxpayer's experience is inadequate, the general experience in the industry may be used until such time as the taxpayer's own experience forms an adequate basis for making the determination. The estimated remaining useful life may be subject to modification by reason of conditions known to exist at the end of the taxable year and shall be redetermined when necessary regardless of the method of computing depreciation. However, estimated remaining useful life shall be redetermined only when the change in the useful life is significant and there is a clear and convincing basis for the redetermination. For rules covering agreements with respect to useful life, see section 167(d) and § 1.167(d)-1.

(c) *Salvage.* Salvage value is the amount (determined at the time of acquisition) which is estimated at the time of acquisition) which is estimated will be realizable upon sale or other disposition of an asset when it is no longer useful in the taxpayer's trade or business or in the production of his income and is to be retired from service by the taxpayer. Salvage value shall not be changed at any time after the deter-

mination made at the time of acquisition merely because of changes in price levels. However, if there is a redetermination of useful life under the rules of paragraph (b), salvage value may be redetermined based upon facts known at the time of such redetermination of useful life. Salvage, when reduced by the cost of removal, is referred to as net salvage. The time at which an asset is retired from service may vary according to the policy of the taxpayer. If the taxpayer's policy is to dispose of assets which are still in good operating condition, the salvage value may represent a relatively large proportion of the original basis of the asset. However, if the taxpayer customarily uses an asset until its inherent useful life has been substantially exhausted salvage value may represent no more than junk value. Salvage value must be taken into account in determining the depreciation deduction either by a reduction of the amount subject to depreciation or by a reduction in the rate of depreciation, but in no event shall an asset (or an account) be depreciated below a reasonable salvage value. See, however, § 1.167(b)-2(a) for the treatment of salvage under the declining balance method. The taxpayer may use either salvage or net salvage in determining depreciation allowances but such practice must be consistently followed and the treatment of the costs of removal must be consistent with the practice adopted. For specific treatment of salvage value see §§ 1.167(b)-1, 2, and 3. When an asset is retired or disposed of, appropriate adjustments shall be made in the asset and depreciation reserve accounts. For example, the amount of the salvage adjusted for the costs of removal may be credited to the depreciation reserve.

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Sec. 1.167(a)-8. Retirements—(a) *Gains and losses on retirements.* For the purposes of this section the

term "retirement" means the permanent withdrawal of depreciable property from use in the trade or business or in the production of income. The withdrawal may be made in one of several ways. For example, the withdrawal may be made by selling or exchanging the asset, or by actual abandonment. In addition, the asset may be withdrawn from such productive use without disposition as, for example, by being placed in a supplies or scrap account. The tax consequences of a retirement depend upon the form of the transaction, the reason therefor, the timing of the retirement, the estimated useful life used in computing depreciation, and whether the asset is accounted for in a separate or multiple asset account. Upon the retirement of assets, the rules in this section apply in determining whether gain or loss will be recognized, the amount of such gain or loss, and the basis for determining gain or loss:

(1) Where an asset is retired by sale at arm's length, recognition of gain or loss will be subject to the provisions of sections 1002, 1231, and other applicable provisions of law.

*   *   *   *   *

Sec. 1.167(a)-10. When depreciation deduction is allowable. (a) A taxpayer should deduct the proper depreciation allowance each year and may not increase his depreciation allowances in later years by reason of his failure to deduct any depreciation allowance or of his action in deducting an allowance plainly inadequate under the known facts in prior years. The inadequacy of the depreciation allowance for property in prior years shall be determined on the basis of the allowable method of depreciation used by the taxpayer for such property or under the straight line method if no allowance has ever been claimed for such property. The preceding sentence shall not be construed as precluding application of any method provided in section

167 (b) if taxpayer's failure to claim any allowance for depreciation was due solely to erroneously treating as a deductible expense an item properly chargeable to capital account. For rules relating to adjustments to basis, see section 1016 and the regulations thereunder.

(b) The period for depreciation of an asset shall begin when the asset is placed in service and shall end when the asset is retired from service. A proportionate part of one year's depreciation is allowable for that part of the first and last year during which the asset was in service.

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Sec. 1.167(b)-0. Methods of computing depreciation.—(a) *In general.* Any reasonable and consistently applied method of computing depreciation may be used or continued in use under section 167. Regardless of the method used in computing depreciation, deductions for depreciation shall not exceed such amounts as may be necessary to recover the unrecovered cost or other basis less salvage during the remaining useful life of the property. The reasonableness of any claim for depreciation shall be determined upon the basis of conditions known to exist at the end of the period for which the return is made. It is the responsibility of the taxpayer to establish the reasonableness of the deduction for depreciation claimed. Generally, depreciation deductions so claimed will be changed only where there is a clear and convincing basis for a change.

*   *   *   *   *

Sec. 1.167(b)-1. Straight line method.—(a) *Application of method.* Under the straight line method the cost or other bases of the property less its estimated salvage value is deductible in equal annual amounts over the period of the estimated useful life of the

property. The allowance for depreciation for the taxable year is determined by dividing the adjusted basis of the property at the beginning of the taxable year, less salvage value, by the remaining useful life of the property at such time. For convenience, the allowance so determined may be reduced to a percentage or fraction. The straight line method may be used in determining a reasonable allowance for depreciation for any property which is subject to depreciation under section 167 and it shall be used in all cases where the taxpayer has not adopted a different acceptable method with respect to such property.

APPENDIX B

PERLMAN, BALDRIDGE, LYONS AND BROWNING
Suite 1021, Tower Building
14th and K Streets, Northwest
Washington 5, D. C.

December 10, 1955

The Commissioner of Internal Revenue
Internal Revenue Service
12th Street and Constitution Avenue,
Washington 25, D. C.

Attention: T. P.

Dear Mr. Commissioner:—

This letter is written to suggest certain modifications in the proposed regulations under section 167 of the Internal Revenue Code of 1954, pursuant to Notice of Proposed Rule Making appearing in the Federal Register of Friday, November 11, 1955 (20 F. R. 8454 et seq.) and entitled "Income Tax: Taxable Years Beginning after December 31, 1953; Depreciation."

This submission is on behalf of the American Automotive Leasing Association, an Illinois non-profit corporation

composed of companies engaged in the business of leasing automobiles to industrial and commercial companies on long-term leases, i.e., for periods of a year or more, some leases being for as long a period as two years. The lessor companies acquire their vehicles in fleets, and, when the vehicles are no longer suitable for leasing purposes, they are disposed of by the lessor companies in fleets at wholesale. The vehicles which these lessor companies lease do not constitute property held primarily for sale to customers in the ordinary course of trade or business. See Rev. Rul. 54-229; I.R.B. 1954-25.

During the period of the leases, the lessor companies supply the lessees with the car and its equipment, together with license plates and insurance against collision, fire and theft. The lessors also bear the cost of all mechanical repairs and maintenance, replacement of worn tires and tubes, lubrication and oil changes, repairs caused by accident, and also the cost of anti-freeze and tire chains, when necessary. The lessees' only expense is the monthly rental.

Our chief interest in the new proposed depreciation regulations may be briefly summarized as follows: It is our fear that the new regulations might be interpreted to require, as a matter of course and regular procedure in all cases, a recalculation of depreciation allowances taken in earlier years, even though the allowances, when taken, were based on reasonable estimates and resulted in essentially reasonable depreciations, such recalculation to be determined after the leased cars were sold and the actual amount of salvage realized would be known precisely. The recalculation would consist of subtracting the actual salvage realized from the cost of other basis and depreciating that net amount over the years the cars were in service. The reasons why those fears are very real will be shown in more detail below, but first I should like to set forth briefly what our present practice is in general and why the matter is of such great concern and importance to us.

It has been, and still is, the practice of most of these companies to depreciate their leased vehicles at a rate of about 2½% of cost a month, or about 30% a year. Not all companies use the precisely identical rate, but for the purposes of this letter it is fair to assume at this point a depreciation rate of 2½% of cost a month, or 30% a year. The use of this rate has resulted in some years, after the cars are disposed of at wholesale on resale, in a small profit per car over cost less depreciation taken; in other years, small losses per car have been sustained. Whether a profit has been made or a loss sustained has depended, of course, on the condition of the used car market at the time of sale. Profits have been taken as capital gains in the years realized and losses have been treated as losses in the years they were sustained. The results of the rate and method used have been approved in the past by the Internal Revenue Service, and, again for the purposes of this letter, it may be assumed that, depending on the condition of the used car market in future years, relatively small losses will be sustained or relatively small profits will be realized. It should be emphasized at this point that it is in no sense the purpose of this letter to urge that any particular rate or method of depreciation be approved for future use. It is realized that that is not appropriate here.

What our companies want here, and the sole purpose for which this letter is written, is assurance that they may continue the general practice which they have consistently used, and which they now use, of making a reasonable estimate of a depreciation allowance at the time their vehicles are put in service, of taking depreciation on that basis while the vehicles are useful in their business, and of treating, as a gain or loss in the year of resale, any small subsequent profit or loss that might result. The realization of such a profit or loss should not be the occasion to recalculate the depreciation over the years the vehicles were in service, where the over-all result has been reasonable.

While this problem is important to all taxpayers using depreciable property in their businesses, it is obvious that the problem is of particular importance with respect to companies engaged in the business of leasing automobiles. In most businesses, depreciable property is used merely in connection with the taxpayer's business, which usually has no direct relationship to the depreciable property—for example, the use of a cash register or a show case by a retail merchant. The depreciation rate of that register or show case, while important, is not of prime importance in the taxpayer's business. But in our business, dealing in the very property to be depreciated—i.e., the leasing of automobiles—constitutes the very essence and, indeed, the entire business of these companies. There is probably no other single factor in determining whether a profit has been made or a loss sustained more important than the allowable depreciation. Any retroactive changes in depreciation for these leased cars, when the original plan was reasonable when made, can very easily result in retroactively converting profitable years into losing years or retroactively giving rise to claims for more taxes—all this at a time when it is too late for the companies to refix their rental rates retroactively, and after those rates had been fixed on the assumption that the reasonable estimates for depreciation would stand. The possibility of such instability unquestionably affects the bank credit of these companies and throws their entire operations into serious jeopardy. It is because of this almost unique situation with respect to these companies and the very serious problem presented to them that this letter is being written.

While it is almost inconceivable that the proposed regulations on depreciation were intended to have the effect that I have suggested, the fear that they might be so interpreted is not without some justification. The new regulations define with great care the elements that go into making up the depreciation allowance, and the concepts of useful life

and salvage value are spelled out in detail. But when the regulations are read as a whole, one does not come away with the certain understanding that the depreciation allowance provided for in the regulations is what such an allowance always had been in the past—a reasonable estimate in advance, rather than a specific figure determined definitively after the fact. For example, in section 1.167(a)-1(c), salvage value is defined as the "amount realizable upon sale or other disposition of an asset when it is no longer useful in the taxpayer's trade or business or in the production of his income and is retired from service by the taxpayer." Such an amount seems to be a specific sum. In section 1.167(a)-1(a), the regulations, in describing the depreciation allowance, state that it is the amount to be set aside yearly in accordance with a plan "so that the aggregate of the amounts set aside, *plus the salvage value*, will, at the end of the estimated useful life of the depreciable property, equal the cost, etc." (Underscoring supplied). This conveys the impression that the depreciation allowance must return the cost less salvage determined with mathematical precision, after a sale. Again in section 1.167(b)-0(a), it is stated that "Regardless of the method used in computing depreciation, deductions for depreciation shall not exceed such amounts as may be necessary to recover unrecovered cost or other basis *less salvage* during the remaining useful life of the property." (Underscoring added). Again, it would seem that strict application of this rule would require a redetermination of *salvage* after the event, with the consequent recalculation of depreciation over the years it had been taken. The possibility of this of this interpretation is not entirely imaginary, particularly when the sentence last quoted is contrasted with the statement appearing as long ago as 1931 in Bulletin F (Income Tax, Depreciation and Obsolescence), p. 10: "In no instance may the total amount allowed be in excess of the amount represented by the difference between the cost

or other allowable basis *and the salvage value which reasonably may be expected to remain at the end of the useful life of the property in the trade or business.*" The identical rule appears in the Revised Bulletin F of 1942. Such a rule leaves no doubt that it is the reasonably estimated salvage that is controlling.

We are not alone in our fear that the proposed regulations might give rise to the new, even though unintended, rule which I have discussed. For example, Research Institute's Taxation Report of November 17, 1955, after stating that the new regulations "make drastic changes" and "take a far tougher view of salvage," makes the following observation:

> These new regulations would virtually bar any capital gains on disposition of depreciable property (other than breeding, dairy and draft animals which generally have a zero basis to start). If the sales price exceeded the depreciated basis, the Treasury could claim that the salvage value was equal to the sales price and reduce the depreciation deduction by the amount of the "gain."

The possibility of this interpretation has also been expressed in legal and accounting circles. While our group is not suggesting the adoption of a rule that will guarantee a capital gain which the above quotation states the proposed regulation would necessarily eliminate, we are greatly concerned, as already noted, about the adoption of a rule which will provide the instability that goes with any regular recalculations.

It is my understanding that the regulations were, in fact, not intended to have that result. Such a result would impute to the drafters a purpose to burden the Internal Revenue Service with an impossible administrative task and to harass a multitude of taxpayers with constant recalculation of their taxes.

Therefore, it is suggested that the following modifications be incorporated into the proposed regulations:

1. In the second sentence of section 1.167(a)-1(a) add the words "reasonably estimated" before the word "salvage," so that the sentence would read as follows:

> The allowance is that amount which should be set aside for the taxable year in accordance with a reasonably consistent plan (not necessarily at a uniform rate), so that the aggregate of the amounts set aside, plus the *reasonably estimated* salvage value, will, at the end of the estimated useful life of the depreciable property, equal the cost or other basis of the property, as provided in section 167(f) and § 1.167(f)-1.

2. In the third sentence of section 1.167(a)-1(a), substitute the words "reasonably estimated" for the word "reasonable" before the word "salvage" so that the sentence will read as follows:

> An asset shall not be depreciated below a *reasonably estimated* salvage value under any method of computing depreciation.

3. In the fourth sentence of section 1.167(b)-o-(a), add the words "the reasonably estimated" before the word "salvage" so that the sentence will read as follows:

> Regardless of the method used in computing depreciation, deductions for depreciation shall not exceed such amounts as may be necessary to recover the unrecovered cost or other basis less *the reasonably estimated* salvage during the remaining useful life of the property.

* * * * * * * * * * *

At this point I should like to call to your attention one other related matter which, I believe, can be remedied by the addition of one sentence to these regulations.

It is my understanding that a few of our companies have followed the practice of taking a larger depreciation during the first year of service of the vehicles than in the second. While this practice may be referred to as "accelerated" depreciation, or a declining balance method, it is, of course, not the statutory method referred to in section 167(b)(2) of the Internal Revenue Code. Where such a practice has resulted in a "reasonable allowance" and where it will continue to do so, it is, of course, the desire that there be no necessity for a change. It seems quite clear that it is the intent of the proposed regulations to authorize the continuation of such plans and methods which had previously produced reasonable depreciation allowances. That would seem to be the primary purpose of section 1.167(b)-o-(b) of the proposed regulations. But it is not entirely certain that the section completely accomplishes its purpose. For example, the section accepts "the declining balance method with the rate limited to 150 percent of the applicable straight line rate." It must necessarily have approved that method without regard to the limitations of section 167(c) of the Internal Revenue Code. But the limitations of section 167(c) are in turn applicable to the method set forth in section 167(b)(2) of the Code which refers to a declining balance method using a rate *not exceeding* twice the straight line rate; *thereby including a method using a 150% rate.* The regulations might, therefore, possibly be interpreted to require compliance with section 167(c) even for those previously using up to a 150% declining balance method. It seems to me that the regulations should make clear that the methods intended to be approved in section 1.167(b)-o-(b) of the regulations were approved without regard to the limitations of section 167(c) of the Code. This is important because there are open years for which such limitations could not have been complied with and for which the methods used must not be deemed to have been within section 167(b)(2). This

can be accomplished by inserting after the first sentence of section 1.167(b)-o-(b) the following sentence:

> The limitations of section 167(c) shall not be applicable to these methods.

* * * * * * * * * *

Very truly yours,

s/ Ellis Lyons
Ellis Lyons

AUG 24 1965

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In the

Supreme Court of the United States

October Term, 1965

No. 25

FRIBOURG NAVIGATION COMPANY, INC.,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF OF AMICUS CURIAE

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INDEX

AUTHORITIES CITED

CASES: **Page**

MISCELLANEOUS: **Page**

In the

Supreme Court of the United States

October Term, 1965

No. 23

FRIBOURG NAVIGATION COMPANY, INC.,
Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF OF AMICUS CURIAE

QUESTION PRESENTED

Whether, as a matter of law, the unanticipated sale of depreciable property in the middle of its estimated "useful life" for an amount in excess of its depreciated basis at the beginning of the year of sale necessarily bars the deduction of depreciation on the property for the period of its use during the year of sale.

STATEMENT OF INTEREST OF AMICUS CURIAE

This brief is filed by the undersigned attorneys as friends of the Court, with the consent of the petitioner and the respondent. The undersigned attorneys represent the taxpayer in the almost identical case of *S & A Co. v. United States*, 218 F. Supp. 677 (D. Minn. 1963), *aff'd*, 338 F.2d 629 (8th Cir. 1964), *petition for cert. filed* (No. 862, 1964 Term; renumbered No. 50, 1965 Term). The undersigned attorneys also are concerned, in their capacity as members of the Bar, with the serious implications of the theories proposed by the respondent and accepted both by the Tax Court[1] and by a majority of the Court of Appeals[2] in this case, as these theories would (if accepted by this Court) overturn over 40 years of relevant precedents and adversely affect numerous other taxpayers.

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[1]The opinion of the Tax Court is not officially reported, but it is unofficially reported at 21 CCH Tax Ct. Mem. 1533 (1962), and is reprinted at pages 2 to 18, inclusive, of the Transcript of Record before the Court in this case.

[2]The opinion of the Court of Appeals is reported at 335 F.2d 15 (1964). The majority opinion is reprinted at pages 76 to 82, inclusive, of the Transcript of Record, and Judge Moore's opinion in dissent is reprinted at pages 82 to 90, inclusive.

SUMMARY OF ARGUMENT

The Tax Court and a majority of the Court of Appeals in this case accepted respondent's novel theory that, as a matter of law, the sale of a depreciable asset conclusively terminates its previously estimated "useful life", and the sale price received for the asset automatically supplants any previously estimated "salvage value" of the asset for purposes of computing depreciation on the asset in the year of sale, and, therefore, the unanticipated sale of a depreciable asset in the middle of its estimated "useful life" for an amount in excess of its depreciated basis at the beginning of the year of sale necessarily bars any deduction for depreciation of the asset for the period of its use in that year. The lower courts denied the deduction for depreciation despite the fact that the "useful life" and "salvage value" of the asset involved which were used by taxpayer in computing the claimed depreciation had originally been approved by the Internal Revenue Service, and the reasonableness and accuracy of the "useful life" and "salvage value" so approved have not been questioned in this proceeding. In accepting this theory, and concluding that petitioner was not entitled to any deduction for year-of-sale depreciation of an asset sold in 1957, the lower courts completely misunderstood fundamental principles of depreciation accounting which are embodied in the basic statutory provision and which have been recognized, enunciated, refined, and followed by this Court, misinterpreted two decisions of this Court and a decision of the Court of Appeals for the Sixth Circuit, misapplied the pertinent provisions of the Treasury Regulations, ignored the basic dichotomy in the tax law between depreciation of property during the period of its use and recognition of gain or loss on its disposition, which is reflected in over 40 years of judicial precedents and administrative rulings and practice, ignored clear indicia of Congressional intent as evidenced for more than 20 years, and, in general, gave their stamp of approval

to a novel theory which has been thoroughly discredited in the overwhelming majority of contemporary court decisions.

The Court of Appeals, viewing the purpose of depreciation for income tax purposes to be to account for "the diminution of the asset's value each year", applied a literal meaning to the term "depreciation" for tax purposes. However, any use or meaning of the term "depreciation" as the converse of "appreciation" is irrelevant in determining the income tax allowance for depreciation. This irrelevance is made abundantly clear in basic, well-established accounting principles of depreciation, which this Court has held to be the matrix of the income tax allowance for depreciation, and in the pertinent statutory provision, Section 167(a) of the Internal Revenue Code, which allows as a depreciation deduction "a reasonable allowance for the exhaustion, wear . . . tear . . . [and] obsolescence" "of property used in the trade or business", and in the depreciation formula first enunciated by this Court in *United States v. Ludey*, 274 U.S. 295 (1927). These authorities all recognize that the term "depreciation" for income tax purposes means the physical and functional deterioration of property with use and lapse of time, and that depreciation accounting is a process of cost *allocation*, not of asset valuation.

The depreciation formula of the *Ludey* case recognizes that, in computing depreciation for income tax purposes, the allocable sum is original cost of an asset less its estimated "salvage value" and that the rate of allocation is determined by the asset's estimated "useful life". This Court, in *Massey Motors, Inc. v. United States* (decided with *Commissioner v. Evans*), 364 U.S. 92 (1960), and in *Hertz Corp. v. United States*, 364 U.S. 122 (1960), refined that formula, entirely consistent with well-established accounting authorities, by holding that "useful life" is the period, determined at the time of acquisition, for which the taxpayer *reasonably expects* the property to be useful in the business, and that

"salvage value", also determined at the time of acquisition, is the amount which the taxpayer *anticipates* the asset will be worth at the end of that "useful life". The Tax Court in this case erroneously assumed that this Court in *Massey* and *Hertz* had discarded the "old, well-established rules relating to depreciation allowances." In fact, those cases merely restated the principles outlined above and held that the *original* estimates of "useful life" and "salvage value" must take into account the taxpayer's established practices in disposing of assets of the type involved prior to the expiration of their normal physical life.

The decision of the Sixth Circuit in *Cohn v. United States*, 259 F.2d 371 (6th Cir. 1958), simply applied these well-settled principles to the peculiar facts involved in that case, *viz.*, a sale at or near the end of redetermined "useful life", and in no way supports the decisions of the lower courts in this case. The Tax Court in this case erroneously believed that *Cohn* also had discarded the "old, well-established rules", and a majority of the Court of Appeals concluded in error that respondent's new theory was "suggested by" the decision in *Cohn*.

The Treasury Regulations simply mirror the depreciation formula developed in accordance with well-established accounting principles and enunciated by this Court in *Ludey* and later refined and followed by this Court in *Massey* and *Hertz*, and also make it clear that, once properly estimated at the time of acquisition, "useful life" may not later be redetermined unless there is a "clear and convincing basis for" the change, and "salvage value" may not later be redetermined "merely because of changes in price levels," but may be redetermined only in connection with a redetermination of "useful life" and at no other time.

The dichotomy in the tax law between depreciation deductions while property is used in the trade or business and

computing and recognizing gain on the subsequent disposition of the asset is expressly recognized in respondent's Treasury Regulations. For over 40 years, from 1920 until the trial of this case in the Tax Court, respondent's long-standing practice of allowing depreciation in the year of sale of depreciable assets at a profit was fully reflected in his published rulings, practice, and acquiescence and in long-standing judicial precedents approving respondent's practice, including this Court's decisions in *Eldorado Coal & Mining Co. v. Mager,* 255 U.S. 522 (1921), and in *United States v. Ludey, supra,* and numerous other decisions of many lower courts including the Second Circuit's decisions in *Beckridge Corp. v. United States,* 129 F.2d 318 (2d Cir. 1942), and in *Kittredge v. Commissioner,* 88 F.2d 632 (2d Cir. 1937). All of these judicial and administrative precedents are completely consistent with well-established accounting principles in flatly contradicting respondent's present theory that a sale at a gain of a depreciable asset bars a deduction for depreciation in the year of sale and plainly indicate that such depreciation in fact is allowable.

Since 1918, Congress has repeatedly reenacted the basic statutory provision relating to the allowance for depreciation without relevant change. Moreover, from 1942 to 1962, Congress first granted, then expanded capital gains treatment to gains realized on the sale of depreciable assets, in spite of persistent warnings from the Treasury Department that this favorable treatment resulted in so-called "abuses." During that period, Congress considered and uniformly rejected proposed legislation designed to eliminate or to reduce these "abuses". Not until 1962, however, did Congress act upon any of these recommendations, and in 1962 and again in 1964 Congress approached the problem, prospectively, solely in terms of the nature of the gain recognized and *not* through a change in the long-standing statutory scheme pertaining to

depreciation deductions. By its reenactment of the depreciation provision in the light of an established administrative and judicial interpretation, Congress is presumed to have approved and adopted that interpretation.

These well-established principles of depreciation accounting, which were ignored by the lower courts in this case, have been applied in the overwhelming weight of contemporary court decisions in which respondent's new theory has been flatly rejected. The most carefully considered and thorough of these decisions is found in the opinion of Judge Blackmun in the case of *United States v. S & A Co.*, 338 F.2d 629 (8th Cir. 1964), *affirming* 218 F. Supp. 677 (D. Minn. 1963), *petition for cert. filed* (No. 862, 1964 Term; renumbered No. 50, 1965 Term). In the *S & A Co.* case, the Court of Appeals for the Eighth Circuit analyzed the applicable principles and reached conclusions identical in almost every respect with those urged in this brief. While the court considered all of the relevant arguments, its key comment is found in this statement:

> . . . There is no absolute identity of salvage value with sales price. The one is not necessarily equivalent to the other. Neither the statute nor the regulations equate them or make an exception out of the sale year. The emphasis, as has been noted, is, instead, on the estimate of salvage value, on such estimate at acquisition, on redetermination as the exception, on the distinct possibility of gain or loss on disposition, and on divorcement of salvage value from price level fluctuations.[3]

The decision of a majority of the Court of Appeals in this case, in parting company with all recognized principles of depreciation accounting as developed and followed in a long line of judicial and administrative precedents and accounting authorities and as evidenced in over 20 years of clear indicia of Congressional intent, is erroneous and should be reversed.

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[3] 338 F.2d at 640.

ARGUMENT

PETITIONER IS ENTITLED TO THE DEDUCTION OF $135,367.24 CLAIMED BY PETITIONER ON ITS FEDERAL INCOME TAX RETURN FOR THE YEAR 1957 FOR DEPRECIATION FOR THE PERIOD JANUARY 1, 1957, TO DECEMBER 23, 1957, WITH RESPECT TO THE DEPRECIABLE ASSET WHICH PETITIONER SOLD TO A COMPETITOR ON DECEMBER 23, 1957, PRIOR TO THE EXPIRATION OF THE ESTIMATED "USEFUL LIFE" OF SUCH ASSET.

A. Nature of the controversy.

The sole issue in this case involves a determination whether petitioner is entitled to the deduction of $135,367.24, which petitioner claimed on its federal income tax return for its taxable year 1957, for depreciation for the period January 1, 1957, to December 23, 1957, with respect to the *S.S. Joseph Feuer* (the "*Feuer*"), a Liberty-type dry cargo ship, which petitioner sold to a competitor for $695,500 on December 23, 1957. This determination in turn depends upon whether, as a matter of law, the sale price received for the *Feuer*, which exceeded the undepreciated cost of the vessel on January 1, 1957, determined the "salvage value" of the ship for purposes of computing depreciation in the year of sale, as the respondent contends and as the Tax Court and a majority of Court of Appeals concluded, or whether the sale price merely reflected the market value, and not the "salvage value," of the ship at a particular point in time prior to the expiration of the estimated "useful life" of the ship, as the petitioner and the undersigned attorneys contend.

The pertinent facts may be summarized briefly as follows:[4] Petitioner was organized in 1946 and owned and operated ships for charter to exporters for the shipment of dry bulk cargoes in foreign commerce. (R. 3, 7-8.) On December 21, 1955, petitioner purchased the *Feuer* for $469,000 (R. 4) and thereafter operated it under the American flag as a tramp ship for the carriage of various dry commodities from the United States to Asian and African ports. (R. 7-8.)

Prior to purchasing the *Feuer*, the petitioner applied for and received from the Engineering and Valuation Branch of the Internal Revenue Service a letter ruling dated December 8, 1955, with respect to its depreciation. (R. 4.) The ruling stated that the Internal Revenue Service would accept a "useful economic life" of three years from the date of acquisition and a "salvage value" of $5 per dead weight ton ($54,000) for the *Feuer* and that the *Feuer's* cost of $469,000, less its $54,000 "salvage value", should be spread ratably over its three-year "useful economic life". (R. 4.)

Petitioner claimed deductions for depreciation of the *Feuer* on its federal income tax returns for the years 1955 and 1956 in the respective amounts of $3,786.50 and $138,585.77, leaving an undepreciated cost of $326,627.73 as of January 1, 1957. (R. 4.) The Internal Revenue Service has audited petitioner's income tax returns for 1955 and 1956 and has accepted the depreciation deductions without adjustment. (R. 5.)

The *Feuer* had been built in 1943 for the United States Maritime Commission for emergency use during World War

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[4]The facts before the Court in this case are thoroughly set forth at pages 19 to 75, inclusive, of the Transcript of Record. Inasmuch as the facts are not disputed in this case, and since the Tax Court accurately and completely summarized the pertinent facts in its Findings of Fact, references herein to the pertinent facts will be to the Tax Court's findings as set forth at pages 3 to 11, inclusive, of the Transcript of Record (hereinafter referred to as "R.").

II (R. 4), as part of an accelerated Liberty-type shipbuilding program. In post-war commerce, Liberty ships carried low-paying bulk commodities, principally grain and coal, were slow and had a low cargo capacity and, faced with mounting competition from modern post-war ships, were rapidly becoming obsolete. (R. 8, 10.) However, the economic and market conditions resulting from the blockage of the Suez Canal in 1956-1957 temporarily relieved the precarious economic position of American flag Liberty-type ships. In fact, during this brief crisis the operation of any type of ocean-going vessel, including American flag Liberty-type ships, became highly profitable, and the temporary scarcity of ships caused sales prices of ships to rise sharply. (R. 5.) In January and February of 1957, purchasers were willing to pay as much as $1,000,000 for American flag Liberty-type ships, and as a result the *Feuer* appreciated in value. (R. 5.)

In June of 1957, a competitor of petitioner, the Isbrandtsen Company, Inc., which was engaged in the business of using Liberty-type ships as tramp carriers of grain and other bulk commodities, offered such an excellent price for the *Feuer* that petitioner decided to sell it. (R. 6.) On June 14, 1957, petitioner entered into a contract for the sale of the *Feuer* to Isbrandtsen for $700,000, which amount was reduced to $695,000 as a result of a change in financing. (R. 6.) The contract called for delivery of the *Feuer* to Isbrandtsen in December of 1957, and petitioner made delivery on December 23, 1957. (R. 6.)

Petitioner had not followed a practice of using ships for a short time and then reselling them while still in good operating condition. (R. 6.) Petitioner had not put the *Feuer* up for sale, but had decided to sell the ship solely because Isbrandtsen had offered such an excellent price. (R. 6.) The contract of sale was entered into halfway through the three-year "useful economic life" established for the *Feuer*

by the letter ruling, and when the *Feuer* was delivered to Isbrandtsen one-third of that "useful life" remained. (R. 6.)

By December of 1957, when petitioner delivered the *Feuer* under the June contract of sale, charter rates had fallen sharply (R. 8-9), competition for dry bulk cargoes was increasing (R. 8, 10), Liberty ships were finding it harder to secure cargoes (R. 10), and prices of such ships had fallen to the level of $400,000 to $500,000 (R. 11), all of which confirmed the *Feuer's* obsolescence and the correctness of the estimates of "useful economic life" and "salvage value" made in the letter ruling. Furthermore, scrap steel prices also were falling, and the scrap value of a Liberty ship was between $53,000 and $60,000 (R. 11), almost exactly as established by the letter ruling.

In its federal income tax return for 1957, petitioner reported gross profit of $289,340 from the operation of the *Feuer* up to the date of sale, and also deducted $135,367.24 for depreciation of the *Feuer* from January 1, 1957, to December 23, 1957 (R. 7), under the formula authorized by the letter ruling and approved for prior years. Respondent never has questioned the originally established three-year "useful economic life" for the *Feuer*, nor has he changed the letter ruling as to such "useful economic life" or as to "salvage value". (R. 5.) Nevertheless, respondent disallowed in its entirety the deduction of $135,367.24 for depreciation of the *Feuer* from January 1, 1957, to December 23, 1957, claimed by petitioner on its income tax return for 1957, on the ground that, as a matter of law, the profitable sale of the *Feuer* barred any depreciation deduction for the year of sale. (R. 7.)

In a single-judge memorandum decision, the Tax Court sustained the respondent's disallowance, admitting in the process that it had discarded the "old, well-established rules re-

lating to depreciation allowances", and announced the novel proposition that whenever a depreciable asset is sold, even in the middle of its estimated "useful life", at an amount substantially in excess of its adjusted basis at the beginning of the year of sale, no depreciation is allowable on the asset for that year. In arriving at this new doctrine, the Tax Court relied on three higher court decisions which it erroneously thought had rejected the "old, well established rules": *viz.* the companion decisions of this Court in *Massey Motors, Inc. v. United States,* 364 U.S. 92 (1960), and the decision of the Court of Appeals for the Sixth Circuit in *Cohn v. United States,* 259 F.2d 371 (6th Cir. 1958). (R. 17-18.)

In a two-to-one decision, the Court of Appeals affirmed the judgment of the Tax Court. A majority of the Court accepted the respondent's position that, as a matter of law, a taxpayer is not entitled to a deduction for depreciation in the year of sale with respect to depreciable property sold at a profit, citing only the *Cohn* decision. (R. 78-79, 81.)

Simply stated, the propositions adopted by the Tax Court and by a majority of the Court of Appeals are that, as a matter of law, the sale of a depreciable asset conclusively terminates the previously estimated "useful life" of the asset, and the sale price received for the asset supplants any previously estimated "salvage value" of the asset for purposes of computing depreciation on the asset in the year of sale.

B. The decision of a majority of the Court of Appeals is based upon a complete misunderstanding of fundamental accounting principles of depreciation which are embodied in the basic statutory provision and which have been recognized, enunciated, refined, and followed by this Court.

Two entirely distinct concepts of the term "depreciation" are often confused. Under the dictionary definitions[5] as used in relation to problems not here involved, the term "depreciation" is the converse of *appreciation* and thus means a decline in value not necessarily attributable either to use or to lapse of time. A majority of the Court of Appeals applied this meaning to the word as used in the applicable income tax statute. Its conclusion that, as a matter of law, depreciation is not allowable in the year of the profitable sale of a depreciable asset springs from its premise, unsupported, as we shall see, by statutory, judicial or accounting authority, that "the purpose of the depreciation allowance is to enable the taxpayer to recover the net cost of a wasting asset used in his trade or business by charging *the diminution in the asset's value* each year against the gross income for that year"[6] and that "all that is required is a comparison of the asset's selling price with its adjusted basis" to determine whether or not the asset "costs a taxpayer" anything in the year of sale and, therefore, has "depreciated" in that year for tax purposes.[7]

Accounting authorities have developed recognized concepts of "useful life" and "salvage value" for depreciation purposes. "The useful life of depreciable assets is based on their period of usefulness to the company and not their in-

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[5]Webster's Seventh New Collegiate Dictionary 222 (1963) defines "depreciate" as ". . . to lower the price or estimated value of" and "to fall in value".

[6]R. 80. Italics supplied.

[7]R. 81.

herent life."[8] A "cycle of life is comprehended in the whole period of usefulness of an article in a given position."[9] "Useful life may be less than physical life because of such factors as obsolescence and inadequacy."[10] The service lives of plant and properties may be limited by a variety of physical and functional factors.[11]

"Salvage value" is the "value an article possesses for some use other than that to which it has been devoted."[12] This will be merely junk or scrap value unless the article possesses "another cycle of life."[13] The article "depreciates until it reaches its salvage or scrap value, as the case may be," beyond which point "there is no further depreciation because it enters a second cycle of life or is broken up . . . ."[14]

"Original cost is usually the only factor known definitely which is employed to compute the depreciation charge for a given period. Useful life and salvage value must be estimated."[15] The accounting recognition of depreciation is "necessarily . . . based upon an estimate of useful life."[16] "Salvage value", like "useful life", should be estimated at the time of acquisition."[17] Accounting authorities recognize

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[8]Montgomery, Auditing 271 (8th Ed. 1957) (hereinafter cited as "Montgomery").

[9]Saliers, Depreciation: Principles & Applications 74 (hereinafter cited as "Saliers").

[10]Montgomery at 268.

[11]Paton, Accountants' Handbook 720 (3d Ed. 1944) (hereinafter cited as "Paton").

[12]Saliers at 72.

[13]*Ibid.*

[14]*Ibid.*

[15]Saliers at 130.

[16]Montgomery at 268.

[17]*Id.* at 271.

that "past recoveries on similar assets may provide the basis for an estimate."[18]

Depreciation accounting is from the outset a process of dead reckoning. However, the accounting authorities recognize that the "useful life" of an asset, and thus the depreciation rate, is subject to correction—prospectively—when the evidence clearly indicates that correction is required.[19] Significantly, although the accounting authorities specifically contemplate appropriate prospective changes in estimated "useful life", the authorities do not contemplate changes in the original estimates of "salvage value". To the contrary, they make it abundantly clear that changes in "salvage value" should not be dictated by or be based upon changes in price levels or market values, *whether or not realized through sale of the asset.*[20]

Accountants strenuously object to changes in depreciation accounts to reflect current values. The objections are, in part, based on impracticability,[21] awkwardness and the desire to avoid "radical and tedious adjustments."[22] But the fundamental objection is that the adjustment of depreciation to differences in value at the beginning and end of the accounting period "violates the basic concept of depreciation because it does not fairly allocate the cost of depreciable

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[18] *Id.* at 272.

[19] MONTGOMERY at 271; PATON at 279; SALIERS at 130, 132; Braunstein & Johnson, *Public Utility Depreciation and the Income Tax*, 52 HARV. L. REV. 1077, 1087-88 (1939).

[20] 1 DEWING, THE FINANCIAL POLICY OF CORPORATIONS 537 n. f (5th Ed. 1953) (hereinafter cited as "DEWING"); SALIERS at 61, 68-69.

[21] Accounting Research Bulletin No. 43, ch. 9(A) (Committee on Accounting Procedure, American Institute of Certified Public Accountants, 1953).

[22] SALIERS at 374.

property to income over its useful life."[23] For depreciation accounting is "a process of allocation, not of valuation."[24]

An equally serious objection is that recognition of changes in fair market value would introduce extraneous elements into the depreciation equation. Depreciation for the year "is not intended to be a measurement of the effect of all . . . occurrences."[25] Various elements "to be considered in determination of fair value" are "not necessarily reflected in correct accounting practice. . . ."[26] One such extraneous element is the appreciation resulting from changing price levels or from increased demand or productivity. A valuation may "show that present value of plant is as much as or greater than cost . . . not because depreciation does not exist, however, but because appreciation in some parts has occurred or because a going-concern value has been established."[27] "The impropriety of offsetting depreciation by appreciation is regarded as axiomatic by most accountants."[28]

Clearly, increase in value does not necessarily reflect over-depreciation. And it is equally clear that the sale or other disposition of depreciable property at a profit does not necessarily reflect over-depreciation. "The treatment of the property account in the case of a sale should conform precisely to the treatment required in the case of any retirement. . . . The amount in the depreciation allowance applicable to the particular unit retired should be charged off, and the balance

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[23]MONTGOMERY at 273.

[24]See note 35 *infra* and accompanying text.

[25]*Ibid.*

[26]SALIERS at 71.

[27]*Id.* at 46-47.

[28]PATON at 718.

should be treated as a special profit . . . item."[29] If, for example, a machine having a cost of $1,100, a 10-year estimated "useful life" and an estimated "salvage value" of $100 is retired at the end of the ninth year, nine full years' depreciation ($900) should be charged.[30] The profit or loss upon retirement should be reflected in a "special profit or special loss account" rather than in the depreciation account, so that it "can be excluded from the current expense and revenue data."[31] Some modification of this treatment of retirements might be justified only "where the loss or profit appears to be due to the understatement or overstatement of depreciation throughout the elapsed life rather than to some current and unusual development."[32]

These principles have peculiar force with respect to dispositions in the middle of the estimated "useful life", where the sale price may reflect increased earning capacity. "[P]otential excess of earning capacity may be represented in the accounts . . . when a business is . . . sold. . . . *But this has nothing to do with accounting for depreciation.*"[33]

Accounting authorities recognize that the annual charge for depreciation cannot accurately be measured in terms of a year's actual exhaustion, wear, tear, and obsolescence, since, in the usual case, the monetary impact of these factors, either alone or in combination, cannot for a given year be

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[29] *Id.* at 685.

[30] *Id.* at 742. The author also notes the Internal Revenue Service practice of requiring calculation of depreciation to the day of retirement. *Id.* at 773.

[31] *Id.* at 777.

[32] *Ibid.*

[33] DEWING at 581 n. mmm. Italics supplied.

expressed with reasonable certainty.[34] Thus, these authorities, recognizing that an asset in fact deteriorates with use and the passage of time, hold that the cost of the asset (less its estimated "salvage value") must be allocated over its estimated "useful life," in the expectation that the portion of the cost allocated to and charged against income for a particular year will, as nearly as possible, approximate the average monetary impact on the business of physical and functional deterioration for that year. Accordingly, the well-established accounting concept of depreciation is expressed as follows:

> ***Depreciation accounting*** **is a system of accounting which aims to distribute the cost or other basic value of tangible capital assets, less salvage (if any), over the estimated useful life of the unit (which may be a group of assets) in a systematic and rational manner. It is a process of allocation, not of valuation.** ***Depreciation for the year*** **is the portion of the total charge under such a system that is allocated to the year. Although the allocation may properly take into account occurrences during the year, it is not intended to be a measurement of the effect of all such occurrences.**[35]

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[34] See Accounting Terminology Bulletin No. 1, ¶ 54 (Committee on Terminology, American Institute of Certified Public Accountants, 1953), republished in Accounting Terminology Bulletin No. 1, *Review and Resume*, ACCOUNTING RESEARCH & TERMINOLOGY BULLETINS ¶ 54, at 24-25 (American Institute of Certified Public Accountants, Final Ed. 1961).

[35] Accounting Terminology Bulletin No. 1, ¶ 56 (Committee on Terminology, American Institute of Certified Public Accountants, 1953), republished in Accounting Terminology Bulletin No. 1, *Review and Resume*, ACCOUNTING RESEARCH & TERMINOLOGY BULLETINS ¶ 56, at 25 (American Institute of Certified Public Accountants, Final Ed. 1961); FINNEY & MILLER, PRINCIPLES OF ACCOUNTING—INTERMEDIATE 440 (4th Ed. 1951); KARENBROCK & SIMONS, INTERMEDIATE ACCOUNTING 315 (3d Ed. 1958); MONTGOMERY, AUDITING 260 (7th Ed. 1949). Italics in original. For other authorities recognizing an almost verbatim accounting principle, see, *e.g.*, Cranstoun, *Tangible Fixed Assets*, CONTEMPORARY ACCOUNTING 2, 5 (1945); CURRENT PRACTICE IN ACCOUNTING FOR DEPRECIATION: NATIONAL ASSOCIATION OF ACCOUNTANTS RESEARCH REPORT 3-4 (1958); KENNEDY & MCCULLEN, FINANCIAL STATEMENTS—FORM, ANALYSIS & INTERPRETATION 159 (4th Ed. 1962).

The conclusion is clear. Under well-established accounting principles which, as we shall see, have been embodied in the basic statutory provision, and previously applied by this Court, the sales price received by a taxpayer on the sale of his depreciable assets is not an element in the determination of the taxpayer's deduction for depreciation for the year of sale, regardless of the amount of the sale price, and the gain (or loss) realized on the sale is accounted for separately.

The meaning of the term "depreciation" for income tax purposes is plainly expressed in the basic statutory provision, Section 167(a) of the Internal Revenue Code of 1954, which provides as follows:

> (a) GENERAL RULE.—There shall be allowed as a depreciation deduction a reasonable allowance for the *exhaustion, wear* and *tear* (including a reasonable allowance for *obsolescence*)—
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> (1) of property used in the trade or business, or
>
> (2) of property held for the production of income.[36]

The present statutory language flows uninterruptedly[37] from the Revenue Act of 1918, which authorized deduction of a "reasonable allowance for the exhaustion, wear and tear of property used in the trade or business, including a reasonable allowance for obsolescence."[38] Allowing for minor variations in phraseology, the statutory deduction for depreciation dates back even further, to the origin of the modern income tax in the Revenue Act of 1913, which gave individuals a "reasonable allowance for the exhaustion, wear and tear of property arising out of its use or employment in the busi-

[36]Italics supplied.

[37]INT. REV. CODE OF 1954, §167(a); Int. Rev. Code of 1939, §23(1); Rev. Acts of 1934, 1936, and 1938, §23(1); Rev. Acts of 1928 and 1932, §23(k); Rev. Acts of 1921, 1924, and 1926, §214(a)(8). Rev. Act of 1942, §121(c), expanded the scope of this provision to include property held for the production of income.

[38]Rev. Act of 1918, §214(a)(8).

ness" and corporations a "reasonable allowance for depreciation by use, wear and tear of property, if any".[39]

Neither Section 167(a) nor its legislative antecedents define depreciation in terms of valuation. On the contrary, these statutory provisions take into account the obvious fact that property deteriorates physically and functionally with time and use and define depreciation as an allowance for "exhaustion, wear . . . tear . . . [and] obsolescence." Each year, twelve months' worth of "exhaustion, wear and tear" is totalled up. This is the price the taxpayer pays for owning and using property in his trade or business. This occurs regardless of the market value of the property. Whether that value goes up or down, the elements do their work. Moreover, most property becomes obsolete at varying rates with the passage of time, wholly apart from its physical deterioration.

What happens when a depreciable asset is sold in the middle of a year for an amount in excess of its depreciated basis at the beginning of the year of sale? Does this mean that the property has not sustained any "exhaustion, wear and tear" during the year of sale? Does this mean that even though the property was used during the year prior to its sale and was somewhat older than it was at the beginning of the year the elements as of the beginning of the year of sale suddenly ceased to take their toll? Of course it does not. The asset has continued to depreciate and it always will. The sale price received for the asset does not change the wear and tear upon it.

The emphasis of this Court has been on the taxable year as a unit, and depreciation is to be taken in each year of the depreciating asset's "useful life". In *Virginian Hotel Corp.*

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[39]Rev. Act of 1913, §§ IIB and IIG, respectively.

v. Helvering, 319 U.S. 523, 526, 528 (1943), this Court stated that:

> Congress has elected to make the year the unit of taxation. . . . Thus the amount "allowable" must be taken each year. . . . Congress has provided for deductions of annual amounts of depreciation which, along with salvage value, will replace the original investment of the property at the time of its retirement.

Moreover, in *Massey Motors, Inc. v. United States*, 364 U.S. 92, 104 (1960), and *Hertz Corp. v. United States*, 364 U.S. 122, 126 (1960), this Court recognized that "it is the primary purpose of depreciation accounting to further the integrity of periodic income statements. . . ." Finally, in *Detroit Edison Co. v. Commissioner*, 319 U.S. 98, 101 (1943), this Court observed that "it is sound accounting practice annually to accrue" an aliquot part of the total depreciation allowable over the estimated "useful life" of the depreciating asset.

The effect of the decisions of the lower courts in this case is to destroy the integrity of the periodic income statements through offsetting allowable depreciation in the year of sale against realized appreciation without giving to each class of item the special recognition and treatment intended by the tax statute.

In early cases interpreting the Corporation Excise Tax Act of 1909, this Court announced that the statutory depreciation allowance was for depreciation as "charged in practical bookkeeping."[40] In the Court's view, Congress used the expression "depreciation of property" (which in the 1909 statute was not given any definition similar to that provided

[40]This view, first discussed by this Court in Stratton's Independence, Ltd. v. Howbert, 231 U.S. 399, 423 (1913), was decisively adopted in Von Baumbach v. Sargent Land Co., 242 U.S. 503, 524 (1927).

in 1913 and subsequent years[41]) in the tax statute in "its ordinary and usual sense as understood by businessmen."[42] The Court added that it "is common knowledge that business concerns usually keep a depreciation account, in which is charged off the annual losses for wear and tear, the obsolescence of structures, machinery and personalty in use in the business," and reiterated that "Congress . . . used the term 'depreciation' in its ordinary and usual significance."[43] This Court has more recently observed, in a case involving the modern statutory language, that the connotations of the income tax allowance for obsolescence are those of "accounting and engineering terminology."[44] Since "depreciation is fundamentally an accounting postulate,"[45] the accounting authorities reviewed above are as relevant to this case as the judicial and administrative precedents.

This Court, in interpreting the Revenue Act of 1916[46] in *United States v. Ludey*, 274 U.S. 295 (1927), reviewed the fundamental principles that control the income tax allowance for depreciation. The Court observed that the depreciation allowance "permitted as a deduction from the gross income in determining the taxable income for any year represents the reduction, during the year, of the capital assets through wear and tear of the plant used."[47] The measure of

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[41]Corp. Excise Tax Act of 1909, §38 (Second), permitted deduction of a "reasonable allowance for depreciation of property, if any."

[42]Von Baumbach v. Sargent Land Co., 242 U.S. 503, 524 (1927).

[43]*Id.* at 524-25.

[44]Real Estate Title Co. v. United States, 309 U.S. 13, 16 (1940).

[45]Dewing at 535 n. a.

[46]The 1916 Act authorized deduction of "a reasonable allowance for the exhaustion, wear and tear of property arising out of its use or employment in the business or trade." Rev. Act of 1916, §§ 5(a) (Seventh) and 12(a) (Second).

[47]274 U.S. at 300.

this allowance "is the sum which should be set aside for the taxable year, in order that, at the end of the useful life of the plant in the business, the aggregate of the sums set aside will (with salvage value) suffice to provide an amount equal to the original cost."[48] Mr. Justice Brandies then neatly summarized the concept on which depreciation accounting rests:

> . . . The theory underlying this allowance for depreciation is that by using up the plant a gradual sale is made of it. The depreciation charged is the measure of the cost of the part which has been sold. When the plant is disposed of after years of use, the thing then sold is not the whole thing originally acquired. The amount of the depreciation must be deducted from the original cost of the whole in order to determine the cost of that disposed of in the final sale of the properties.[49]

See also *Detroit Edison Co. v. Commissioner*, 319 U.S. 98, 101 (1943).

It was not until 1960 that this Court had the occasion to analyze the concepts of "useful life" and "salvage value" in terms of the depreciation formula first enunciated by the Court in *Ludey*. In that year the Court handed down its decisions in *Massey Motors, Inc. v. United States*, (decided with *Commissioner v. Evans*), 364 U.S. 92 (1960), and *Hertz Corp. v. United States*, 364 U.S. 122 (1960). The *Massey* and *Hertz* decisions determined the depreciation allowable to taxpayers whose past experience had clearly indicated a consistent utilization of assets for a substantially shorter period than their full physical or economic life. The two decisions covered five fact situations, all involving depreciation of new automobiles.

In each of the five fact situations, the automobiles were regularly sold long before the end of their full physical or

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[48] *Id.* at 300-01.

[49] *Id.* at 301.

economic life. They were sold after the described limited use because demands by customers or other users for later models rendered unsuitable the continued use of the older models in the taxpayers' businesses. In each case the resale price regularly obtainable at the end of such limited use was substantial.

The issue before this Court in the *Massey* and *Hertz* cases was the proper estimated "useful life" and "salvage value" to be used under such circumstances in computing depreciation on the automobiles from the outset of their use. The taxpayers claimed depreciation on their tax returns on the basis of a "useful life" measured by the "estimated physical life" of the automobiles and on the basis of no "salvage value" at the expiration of such period. The Government, on the other hand, defined the term "useful life" for purposes of computing depreciation on the automobiles as "the period during which the taxpayer *anticipates* actually retaining the" automobile in the business.[50]

This Court upheld the Government's position and held that the "useful life" of the automobiles for depreciation purposes was the period of their *reasonably expected* use in the business, as shown by the taxpayers' prior experience with similar automobiles, rather than the full economic or physical life of the automobiles, because the automobiles were "not acquired with intent to be employed in the business for their full economic life."[51] The Court made it clear that the intent not to use assets in the business for their full economic life could be inferred from the practice of the taxpayers of consistently selling such assets prior to the end of such economic life, when it stated that "It is this type of asset, where the *experience of the taxpayer* clearly indicates a utilization of

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[50]364 U.S. at 109. Italics supplied.

[51]*Id.* at 96-97, 105, 107.

the assets for a substantially shorter period than its full economic life, that we are concerned with in these cases."[52]

In terms of "useful life" for depreciation purposes, the Court made it clear that its holding was expressly limited by the definition of "useful life" urged by the Government to a situation where assets are acquired "with intent" that such assets will be "employed in the business" for a period less than the full economic life of such assets and where such intent can be inferred from the consistent practice of the taxpayer of selling such assets substantially prior to the end of their full economic life. For the Government contended, and the Supreme Court agreed, that "useful life" means "the period during which the taxpayer anticipates actually retaining the assets" in the business.[53]

Consistently with its holding on the issue of "useful life," this Court also held that the "salvage value" of the automobiles was the amount which could be expected to be obtained by the taxpayers on resale when the automobiles were no longer useful as rental or company cars. This Court said that Congress "intended that the taxpayer should, under the allowance for depreciation, recover only the cost of the asset less the *estimated* salvage, resale or second-hand value" and that "salvage value must include *estimated* resale or second-hand value."[54] We believe it is clear that the Court was thus discussing the *estimation* of "salvage value" for a new asset; its use of the words "estimated . . . resale or second-hand value" appears to convey the Court's view that

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[52]*Id.* at 96-97. Italics supplied.

[53]*Id.* at 109. See also *The Motorlease Corp. v. United States*, 215 F. Supp. 356, 360 (D. Conn. 1963), *rev'd*, 334 F.2d 617 (2d Cir. 1964), *petition for cert. filed* (No. 685, 1964 Term; renumbered No. 24, 1965 Term); Andrew J. Easter, 23 CCH Tax Ct. Mem. 413, 417 (1964); Katherine Slider, 20 CCH Tax Ct. Mem. 1327, 1329 (1961); John W. Roddy, 20 CCH Tax Ct. Mem. 1129, 1131 (1961).

[54]364 U.S. at 107. Italics supplied.

"salvage value" should not be set at scrap value where the taxpayer's habitual past practice has been to resell the assets for substantial sums for further use. It appears from the Court's opinion in *Massey* that the Court fixed the "salvage value" of the rental and company cars as the resale price which it might be *anticipated* would be obtainable at the end of the properly *estimated* "useful life" of the cars when the cars were no longer useful as rental or company cars.

The Court noted in *Massey* that the traditional accounting formula for depreciation had had the Court's approval since *United States v. Ludey.*[55] Indeed, the Court built its *Massey* and *Hertz* opinions upon the depreciation formula of the *Ludey* case. The *Massey* and *Hertz* opinions do nothing more than refine that formula by making it clear that "useful life" and "salvage value" of newly-acquired assets must be related, where possible, to the taxpayer's past experience with respect to similar assets.

Thus, the depreciation formula adopted and refined by this Court is clear: The allocable sum is original cost less the amount which the taxpayer estimates at the time of acquisition will be the value of the property at the end of its estimated "useful life," and the rate of allocation is the period for which the taxpayer, again at the time of acquisition, reasonably anticipates the property will be useful in the business.

If this Court were to approve the contentions of the respondent the results in many cases would be highly mechanical and arbitrary. For example, a taxpayer on a calendar year basis who negotiates and completes a sale of depreciable property in January would suffer little or no penalty compared to that he would have suffered if he had negotiated and

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[55] *Id.* at 104.

completed the sale in the previous December. In the former case, the depreciation disallowed would be that attributed to a fraction of a month, and in the latter case it would be the depreciation attributed to 11 and a fraction months. And if two depreciable assets are sold, one at a profit and one at a loss, depreciation would be disallowed on the profitable sale and allowed on the loss sale thus decreasing the gain and leaving the loss unchanged, despite the fact that Congress, in Section 1231(a) of the 1954 Code, has made special provision requiring taxpayers to offset net losses against net gains in computing gains or losses recognizable under that provision.

C. The lower courts in this case misinterpreted two decisions of this Court and a decision of the Court of Appeals for the Sixth Circuit.

The Tax Court in this case concluded that the "old, well established rules relating to depreciation allowances" had been discarded by this Court in *Massey* and *Hertz* and by the Court of Appeals for the Sixth Circuit in *Cohn v. United States*, 259 F.2d 371 (6th Cir. 1958),[56] and a majority of the Court of Appeals concluded that respondent's new theory, while admittedly "logically inconsistent",[57] was "strongly suggested"[58] and "adequately supported"[59] by the *Cohn* decision, although it conceded that the *Cohn* decision "could have been more explicit".[60]

It is obvious that the problem before this Court in *Massey* and *Hertz* had absolutely nothing to do with a subsequent

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[56] R. 17-18.

[57] R. 78.

[58] R. 78.

[59] R. 79.

[60] R. 79.

redetermination of "salvage value" upon sale in the middle of "useful life". But respondent apparently views this Court's decisions in those cases as supporting his new theory that "useful life" is the period of actual use and that "salvage value" is sale price whenever obtained. However, in those cases the Government urged, and the Court agreed, that "useful life" means "the period during which the taxpayer anticipates actually retaining the assets" in the business.[61] This view, in complete negation of respondent's new "actual use" theory in determining "useful life",[62] was reiterated in the opinion written in dissent in *Massey* and in concurrence in *Hertz:*

> "In examining the cases, it must be borne in mind that even the Commissioner does not contend that a taxpayer who *happens* to dispose of some asset before its physical exhaustion must depreciate it on a useful life equal to the time it was actually held. It is only when the asset "may reasonably be expected" to be disposed of prior to the end of its physical life that the taxpayer must base depreciation on the shorter period. Reg. Section 1.167(a)-1(b). Therefore, the only cases relevant in this regard are those in which the taxpayer's past experience indicated that assets would be disposed of prior to becoming junk, thus presenting the issue whether the shorter or longer period should control for purposes of depreciation.[63]

Furthermore, it is equally clear that in *Massey* and *Hertz* the Court did not hold that "salvage value" is conclusively

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[61] 364 U.S. at 109.

[62] It is worth noting that respondent himself did not initially interpret this Court's decision in *Massey* to equate "useful life" with actual use. In *John W. Roddy*, 20 CCH Tax Ct. Mem. 1129 (1961), respondent contended, and the Tax Court agreed, that this Court's decision in *Massey* supported respondent's determination that the taxpayer's depreciation deductions with respect to a total of 623 automobiles sold in 1953, 1954, and 1955 should be computed on the basis of an estimated "useful life" for 18 months, even though the taxpayer's actual holding periods for the automobiles sold ranged from 3 *months* to 43 *months*.

[63] 364 U.S. at 113. Italics in original.

fixed by sale price whenever obtained. The Government did not even argue such a proposition in either case. Indeed, in calculating the tax deficiencies of one of the two taxpayers involved in the *Massey* decision,[64] respondent used an estimated "salvage value" of $1,325 for 140 automobiles sold in the same year for $1,380, thereby permitting the automobiles to be depreciated during the year of sale to levels beneath the sales prices received for them. The minor dollar point assumed or conceded by respondent in *Massey* now becomes the sole issue in this case, but clearly the Court in *Massey* did not state or even hint at agreement with respondent's present position. This Court, not having been faced in *Massey* and *Hertz* with the unanticipated sale of an asset substantially prior to the expiration of its properly estimated "useful life", could not possibly have passed on the issue here. It is clear from the Court's opinion in *Massey* that it fixed the "salvage value" of the automobiles as the resale price *which it might reasonably be anticipated at the time of acquisition* would be obtainable at the end of the properly estimated "useful life" of the automobiles when they were no longer useful in the business, and not the amount which might be received on a sale at a prior time.

It is clear that the decision of the Sixth Circuit in *Cohn v. United States*, 259 F.2d 371 (6th Cir. 1958), neither departed from the "old, well established rules relating to depreciation allowances" nor supports the opinions of the lower courts in this case. In *Cohn*, the taxpayers commenced the operation of three flying schools for the Army Air Corps in 1941. In 1942 taxpayers reconsidered the "useful life" of its assets, and in the taxpayers' return for 1942 it was asserted that "useful life" would terminate on December 31, 1944, and ad-

[64] *Evans v. Commissioner*, 264 F.2d 502 (9th Cir. 1959), *rev'd sub nom., Massey Motors, Inc. v. United States*, 364 U.S. 92 (1960).

ditional depreciation was claimed in returns for the years 1942, 1943 and 1944 on that basis. The taxpayers in their returns did not take "salvage value" into account, although operators of similar schools customarily computed depreciation on the basis of an estimated "salvage value" equal to 10 percent of original cost. Respondent set up deficiencies for 1942, 1943 and 1944 by lengthening the estimates of "useful life" but without requiring the taxpayers to take "salvage value" into account. The district court upheld the taxpayers' revised estimates of "useful life" as claimed in their returns, but it also held that in computing depreciation for the year of sale the taxpayers should use a "salvage value" equal to the sale prices received when the assets were sold in 1944. The taxpayers appealed the latter determination to the Sixth Circuit.

In the light of these facts, the scope and meaning of the decision of the Sixth Circuit in *Cohn* are readily discernible: "salvage value" could be redetermined *because*, at the taxpayers' insistence, the "useful life" had been redetermined. The following passage from the brief which the Government filed with the Sixth Circuit in that case makes this at once apparent:

> "*Here, taxpayers sought an adjustment of their depreciation deduction to correct an error in their estimate of the useful lives of the assets in question and the court made this correction in their favor.* At the same time, however, taxpayers seek to cut off any adjustment of an obvious error in their estimate of salvage value. Surely, when the correctness of the amount of a depreciation deduction for a particular year or years is placed in issue, the Commissioner and the Courts are not precluded from looking to all of the factors involved in the computation of the deduction in order to make any adjustment necessary to reach the correct amount of depreciation for that, and future, years. Taxpayers' contention seeks to obtain an adjustment only insofar as it aids them and

> to preclude an adjustment in the Commissioner's favor, thereby preventing the court from determining the correct amount of the deduction. *If taxpayers can adjust the length of the assets' estimated useful lives to fit the realities of the situation, no logical reason presents itself as to why the Government and the court cannot do the same with respect to estimated salvage value.* . . . Although the cited Regulations (Section 1.167(a)-1(c), promulgated under the Internal Revenue Code of 1954), state that salvage value may not be changed merely because of a change in price levels, they also provide that, *if there is a redetermination of useful life,* the salvage value may be redetermined, based upon facts known at the time the useful life is redetermined and, furthermore, they provide that in no event shall the asset be depreciated below a reasonable salvage value. *That is precisely the rule of this case; the useful life was redetermined by the court, and at the time, the salvage value was redetermined* in light of the facts known at the end of the tax year involved; upon this redetermination, the court disallowed any depreciation in excess of the reasonable salvage value found by it.[65]

Presumably in response to the above statement by counsel for the Government, the Sixth Circuit stated:

> But the Government is not contending that salvage value should be adjusted annually in order to conform with current market values, or that it should be adjusted at all on account of "mere fluctuation in market value". In so far as this case is concerned *the issue is whether salvage value can be adjusted at or near the end of the useful life of the asset* when it is shown by an actual sale of the asset that there is a substantial dif-

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[65]Brief for the Appellee, pp. 24-26, in *Cohn v. United States*, 259 F.2d 371 (6th Cir. 1958). Italics supplied. In addition to the remarks contained in the passage of the Government's brief quoted above, the Government also argued that "the District Court did no more than find that the reasonably estimable salvage value was, on the facts of this case, equal to the amounts actually received on the sale of the assets involved", and expressly recognized that the district court's "finding was solely predicated on the facts of this case and, on a different set of facts, it is, of course, possible that an entirely different finding would result." Brief for the Appellee, p. 32, in *Cohn v. United States, supra.*

> **ference between what was estimated and what it actually is. We are not concerned with mere fluctuations or with any fluctuations from year to year. On the contrary, we have a single and final adjustment in the closing of the books on the asset involved. Under such circumstances the practical difficulties urged upon us are largely nonexistent.[66]**

The Sixth Circuit reviewed the "well settled principles governing depreciation deductions." "Useful life", said the Court, "is the period over which the assets may reasonably be expected to be useful to the taxpayer in his trade or business"; because the "property may still have some value when it has completed its usefulness to the business, which will be realized by the taxpayer by its sale at the end of its useful life, it is necessary that this salvage value be deducted from the cost in order to find the net amount which is to be amortized over the years the property is to be used in the business"; and "useful life" and "salvage value" are necessarily estimates "made at the time when the property is first put to its business use."[67]

The Sixth Circuit, after reviewing these settled principles, then considered taxpayers' "fundamental contention" that "salvage value", having been determined at the time of acquisition, cannot be redetermined at any time thereafter. The Sixth Circuit decided that the district court could change "salvage value" *because* it had redetermined "useful life", and then restated and adopted the argument made in the Government's brief. Acknowledging that, in appropriate circumstances under the rule in Section 1.167(a)-1(c) of the Treasury Regulations, depreciation based on estimates of "useful life" and "salvage value" could "be reconsidered through a redetermination of useful life," and that *"at least*

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[66]259 F.2d at 378. Italics supplied.

[67]*Id.* at 377.

at the same time, a reconsideration and redetermination of salvage value" could be made,[68] the Court of Appeals concluded that:

> *Appellants, in filing their actions in the District Court, put in issue the depreciation deductions claimed by them and disallowed by the Commissioner.* In deciding that issue under the circumstances of this case, we are of the opinion that the District Judge was not in error as a matter in law *in considering both useful life and salvage value.* If so, his findings of fact with respect to salvage value are fully supported by the evidence, are not clearly erroneous, and must be sustained.[69]

For respondent now to seize the *Cohn* decision and seek to transform what plainly was a narrow finding of fact into an absolute and sweeping rule of law is obviously unjustified. His reliance on the *Cohn* case requires him to equate "salvage value" at the end of originally estimated "useful life" with actual sale price at mid-life. Respondent thus assumes his conclusion, a conclusion not justified by the holding of the case itself. Under the circumstances in *Cohn*, *viz.*, a redetermination of "useful life" and a sale at or near the end of such "useful life", the court's treatment of the proceeds of such sale as "salvage value" provides no support for the proposition that sale price, irrespective of when obtained, necessarily equals "salvage value". The equivalence of these two concepts, which a majority of the Court of Appeals in this case erroneously considered to be "strongly suggested" and "adequately supported" by *Cohn*, remains respondent's unsupported assumption, and in view of the holding of the Sixth Circuit, narrowed in accordance with the Government's own urging, this supposed equivalence appears to be an erratic afterthought on the part of respondent.

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[68] *Id.* at 378. Italics supplied.

[69] *Id.* at 379. Italics supplied.

It seems clear that the courts in the *Cohn* case would not have permitted a redetermination of "salvage value" which (a) did not occur at or near the end of the "useful life" of the asset, and (b) was not made under circumstances in which a redetermination of "useful life" was permitted. While it might be argued that the district court in the *Cohn* case should have redetermined "salvage value" in the light of the facts known in 1942 when "useful life" was redetermined and without regard to the facts known in 1944, this error (if it be one) obviously does not have any application to the facts in this case where the sale was made at mid-life, and neither petitioner nor respondent had sought or are seeking a redetermination of "useful life". In the light of this comment, the holding of the Sixth Circuit in *Cohn* as quoted above is particularly pertinent in that the Court of Appeals held that the district judge was not in error as a matter of law in considering both "useful life" and "salvage value". Having made this holding, the determination of the precise "salvage value" was clearly a fact question and, as stated by the Sixth Circuit, the value found by the district court was not clearly erroneous and must be sustained.

The essence of petitioner's position in this case is that in the facts of this case "useful life" and therefore "salvage value", as a matter of law, may not be redetermined, and therefore the Tax Court should never have reached the fact question as to what the "salvage value" of the *Feuer* was at the time of sale. If it be assumed that contrary to all of the principles recognized by accounting authorities and the courts, the lower courts in this case can redetermine "useful life" and "salvage value" because of the sale, it does not follow that the sale price (at mid-life) is trustworthy evidence of "salvage value", inasmuch as the sale price in this case was not received at or near the time as of which "salvage value" is to be estimated, *viz.*, at the end of estimated "useful life".

D. The Treasury Regulations are entirely consistent with well-established principles of depreciation accounting and were misinterpreted by the lower courts in this case.

The Treasury Regulations promulgated under Section 167 (a) simply mirror the well-established accounting concepts of depreciation accounting and adopt the depreciation formula of the *Ludey* case as refined by this Court in *Massey* and *Hertz*. The pertinent provisions of these regulations are reprinted in the Appendix. It will suffice here to summarize the thrust of these provisions. In Section 1.167(a)-1(a) the purpose of the depreciation allowance is expressly recognized to be to provide "for the *exhaustion, wear and tear, and obsolescence* of property used in the trade or business or of property held by the taxpayer for the production of income"[70] and it is stated that "the allowance is that amount which should be set aside for the taxable year . . . so that the aggregate of the amounts set aside, plus the salvage value, will, at the end of the *estimated* useful life of the depreciable property, equal the cost or other basis of the property".[71] For this purpose, Section 1.167(a)-1(b) of the regulations defines estimated "useful life" of an asset as "the period over

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[70]Italics supplied. Respondent's interpretation of the term "depreciation" for income tax purposes as physical and functional deterioration of property, as opposed to a reduction in value, finds ample precedent on the first page of respondent's Bulletin "F" (as revised in January, 1942):

> . . . The production of net income usually involves the use of capital assets, which wear out, become exhausted, or are consumed in such use. The wearing out, exhaustion, or consumption usually is gradual, extending over a period of years. *It is ordinarily called depreciation*, and the period over which it extends is the normal useful life of the asset. [Italics supplied.]

[71]Italics supplied. The depreciation formula set forth in the quoted portion of respondent's regulations clearly recognizes depreciation accounting as a process of cost allocation, not of asset valuation, and respondent has made his position in this respect crystal clear in Rev. Proc. 62-21 (Part II), 1962-2 Cum. Bull. 418, 429, where he stated:

> . . . The purpose of the allowance [for depreciation] is to permit taxpayers to recover through annual deductions the cost (or other basis) of the property over its useful economic life.

which the asset *may reasonably be expected* to be useful to the taxpayer in his trade or business".[72] In determining his reasonable expectation of use of depreciable property, the taxpayer is specifically required by Section 1.167(a)-1(b) to consider, *inter alia*, "wear and tear and decay or decline from natural causes", "the normal progress of the art, economic changes, inventions and current developments within the industry and the taxpayer's trade or business," and the taxpayer's experience with similar property. Finally, Section 1.167(a)-1(c) defines "salvage value" as "the amount (*determined at the time of acquisition*) which is estimated will be realizable upon sale or other disposition of an asset"[73] at the end of its estimated "useful life".

Section 1.167(a)-1(c) makes three things clear. First, "salvage value" means the *anticipated* value ("determined at the time of acquisition") of an asset at the end of its anticipated "useful life", also estimated at the time of acquisition, and is thereafter to be redetermined only in extraordinary circumstances. Secondly, in a negative manner, the regulations make it clear that a fluctuation in price levels does not constitute such a circumstance by stating that "salvage value" is not to be redetermined merely because of changes in price levels. In other words, a taxpayer may not increase his annual depreciation deductions to reflect a drop in price levels resulting in a lower estimated "salvage value".[74] In fact, this is expressly forbidden in Section 1.167(a)-1(a) of the regulations where it is stated that the annual "allowance

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[72]Italics supplied.

[73]Italics supplied.

[74]The law is clearly established at the insistence of the Internal Revenue Service that if depreciable assets are sold at a loss, the depreciation deduction is not increased to the extent of the loss. Engineers Ltd. Pipeline Co., 44 T.C. __ No. 25, CCH Tax Ct. Rep., Dec. 27.411 (May 28, 1965); Thos. Goggan & Bro., 45 B.T.A. 218, 224, 225 (1941). See also Rev. Rul. 62-92, 1962-1 Cum. Bull. 29.

[for depreciation] shall not reflect amounts representing a mere reduction in market value." It follows, of course, that the annual allowance for depreciation cannot reflect amounts representing a mere increase in market value, yet this is precisely the position of a majority of the Court of Appeals and of respondent. If mere changes in market value do not affect the determination of the annual allowance for depreciation, the added fact that the change in market value is proved by a sale rather than by some other means should be immaterial. Thirdly, and finally, the regulations state positively that "if there is a redetermination of useful life" under the rules contained in Section 1.167(a)-1(b), "salvage value" may be redetermined on the basis of "facts known to exist at the time of such redetermination of useful life."

Plainly, therefore, once "salvage value" is estimated at the time of acquisition, subsequent events become relevant to justify a change in the originally estimated "salvage value" only in connection with a redetermination of "useful life", and a change in originally estimated "salvage value" is quite clearly forbidden under any other circumstances.

The parenthetical emphasis in Section 1.167(a)-1(c) upon the time when "salvage value" must be determined and the statements as to when it may and may not be redetermined are strengthened when viewed in historical perspective. The originally proposed depreciation regulations under the Internal Revenue Code of 1954, published on September 28, 1954,[75] were followed by the second proposed regulations on November 11, 1955,[76] and thereafter by those finally adopted on June 11, 1956.[77] Significantly, neither the parenthetical statement nor the other italicized portions of Section 1.167

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[75] 19 Fed. Reg. 6229 (1954).

[76] 20 Fed. Reg. 8454 (1955).

[77] T.D. 6182, 1956-1 Cum. Bull. 98, 21 Fed. Reg. 3985 (1956).

(a)-1(c) set forth in the Appendix, as finally adopted, appeared in the earlier proposals. It would be hard to find more explicit evidence of the Treasury's opinion that "salvage value" must be estimated at the time of acquisition and that "salvage value" thus estimated cannot thereafter be redetermined except in connection with a redetermination of originally estimated "useful life".

It is apparent from the foregoing that the estimated "salvage value" of a depreciable asset cannot be redetermined unless there is some "clear and convincing basis" for redetermining the originally estimated "useful life" of the asset in accordance with the rules contained in Section 1.167(a)-1(b). Nothing contained in Section 1.167(a)-1(b) justifies the conclusion that the sale of a depreciable asset in and of itself constitutes a factor to be considered in determining "useful life" of the asset sold. It is true that the regulation purports to set forth merely "some of the factors" to be considered in making such a determination, but it is significant that the sale of an asset is not listed among the factors to be considered. The majority of the Court of Appeals in this case did not discuss or even cite Section 1.167(a)-1(b) or Section 1.167(a)-1(c) of the regulations.

The Tax Court in this case quoted[78] the portion of Section 1.167(a)-1(c) which states that an "asset shall not be depreciated below a reasonable salvage value", and it apparently accepted respondent's argument that, assuming the correctness of respondent's equivalence of "actual sales price" and "salvage value", this provision alone barred petitioner's claimed deduction for depreciation in the year of sale. The assumed equivalence of "actual sale price" and "salvage value" where the sale occurs at mid-life seems such an obvious distortion of the use of words and such a disregard for

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[78]R. 13.

the obvious fact that the value at the time of sale has no relation to the value some time later at the end of the estimated "useful life", that it seems absurd to argue the point. In *S & A Co. v. United States*, 218 F. Supp. 677, 684 (D. Minn. 1963), *aff'd*, 338 F.2d 629, 640 (8th Cir. 1964), *petition for cert. filed* (No. 862, 1964 Term; renumbered No. 50, 1965 Term), both the district court and the Court of Appeals for the Eighth Circuit flatly rejected this assumed equivalence or identity of "actual sale price" and "salvage value".

A similar flaw is present in the Court of Appeal's use[79] of the statement in Section 1.167(b)-0(a) of the regulations that the "reasonableness of any claim for depreciation shall be determined upon the basis of conditions known to exist at the end of the period for which the return is made." The majority expressed its conclusion that this provision entitled respondent to substitute a "known" sale price for a previously estimated "salvage value".[80] However, this conclusion is valid only if it be assumed that the proceeds of an unanticipated sale of depreciable assets, which sale takes place well before the termination of the "useful life" of those assets in the business, constitute the "salvage value" of such assets. By permitting respondent to assume the point he was required to demonstrate, the Court of Appeals accepted respondent's contention that when an asset is sold the "salvage value" becomes "known" and can be substituted for a "less reliable" previous estimate. Such a substitution would be proper, however, only if the automatic equivalence of sale price and "salvage value" were established.

The Treasury Regulations, therefore, far from establishing the equivalence of "salvage value" and actual sale price when-

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[79] R. 80-81.

[80] R. 81.

ever obtained, all reflect the traditional view of depreciation established by over 40 years of judicial and administrative authority. "Useful life", it will be recalled, is defined as "the period over which the asset may reasonably be expected to be useful to the taxpayer in his trade or business or in the production of his income," and not, as respondent and a majority of the Court of Appeals apparently would have it, as "the period over which the asset may reasonably be expected to be useful to the taxpayer *or the period during which it is actually held by the taxpayer, whichever is less.*" "Salvage value" is defined as "the amount (determined at the time of acquisition) which is estimated will be realizable upon sale of other disposition of an asset when it is no longer useful in the taxpayer's trade or business . . . and is to be retired from service by the taxpayer." It is not defined as "the amount (determined at the time of acquisition) which is estimated will be realizable upon sale . . . of an asset when it is no longer useful . . . *or the amount which is actually realized on sale at any time, whichever is greater.*"

E. The majority of the Court of Appeals ignored the relationship between depreciation, on the one hand, and gain or loss on sale, on the other hand, and the clearly-defined dichotomy between these concepts which is expressed in the tax statute and in the Treasury Regulations and which has been recognized in long-standing judicial precedents and administrative practice.

The accounting authorities discussed above recognize a clearly-defined dichotomy between depreciation of an asset during its period of use in the business and the realization of gain or loss on the subsequent disposition of the asset. The dichotomy, ignored by the majority of the Court of Appeals in this case, is firmly imbedded in the basic statutory provision.

The statutory provisions of the 1954 Code relating to the

determination of gains and losses on property (Sections 1001 and 1002) require downward adjustments in basis for depreciation allowed or allowable (Sections 1011 and 1016(a)(2)).[81] Therefore the gain taxed on a profitable sale is increased to the extent of any depreciation deductions allowed for periods prior to the date of sale.

Section 167 of the Code was intended to require and in fact requires only an accounting for an allocation of depreciation during the period an asset is used in the trade of business, and Section 1231 of the Code was intended to deal with the method of taxing gain or loss (determined in accordance with Sections 1001, 1002, 1011 and 1016(a)(2)) resulting from market fluctuations on the subsequent disposition of the asset. Surely, both respondent and a majority of the Court of Appeals would accept the proposition that (except to the extent Section 1245 or Section 1250 now applies) *all* gains or losses recognizable[82] on the disposition of depreciable assets used in the trade or business for more than six months are accountable for under Section 1231, and nowhere else, including *all* gain resulting from the deduction for depreciation in years prior to the year of sale in amounts in

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[81]Section 1001(a) provides that "the gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis provided in section 1011 for determining gain"; Section 1001(c) provides that "the extent to which gain . . . shall be recognized . . . shall be determined under section 1002": and section 1002 states that, except to the extent otherwise provided, "the entire amount of the gain . . . determined under section 1001, shall be recognized." Section 1011 provides that the adjusted basis for determining gain or loss shall be the basis "adjusted as provided in section 1016." And section 1016(a)(2) requires that basis be reduced "for exhaustion, wear and tear, obsolescence, amortization, and depletion" previously allowed or allowable with respect to the asset sold. INT. REV. CODE OF 1954, §§ 1001(a), 1001(c), 1002, 1011, and 1016(a)(2).

[82]Congress has not seen fit to provide for the "recognition" of all gains or losses "realized" on the disposition of property. For example, where, as in this case, a corporation adopts a plan of complete liquidation and within 12 months thereafter distributes all of its assets in complete liquidation, the corporation recognizes none of the gains and losses which it realizes on the disposition of property within that 12-month period. INT. REV. CODE OF 1954, §337(a).

excess of the actual "exhaustion, wear . . . tear . . . [and] obsolescence" experienced with respect to the property. The fact that Section 1231 provides a mechanics for adjusting or compensating for such "excessive" depreciation in prior years does not justify using a different method, *viz.,* reduction of the depreciation allowance for the current year, for adjusting and compensating either for year-of-sale depreciation (whether or not excessive) or for factors such as appreciation in market value. On the contrary, the mere existence of Section 1231 with its provisions for adjusting and correcting for excessive depreciation and for reaching appreciation in market value is some evidence that Congress intended that *all* such items be reached by this device. This obviously does not prevent correcting errors in depreciation for the year of sale directly, but as already apparent it basically is the position of taxpayers that the depreciation claimed in this case in the year of sale does not involve any error for the year of sale in that there was "exhaustion, wear . . . tear . . . [or] obsolescence" in such year of sale reflected in the petitioner's acquisition-time estimates for "useful life" and "salvage value" which are not questioned by the respondent.

It is noteworthy that Congress as a matter of policy has allowed taxpayers to deduct depreciation in excess of anticipated "exhaustion, wear . . . tear [and] . . . obsolescence" in numerous situations including first year depreciation of 20 per cent (Section 167(b)(2), (3), and (4)) and accelerated depreciation (Section 179). In such cases it would normally be expected that a sale of such assets at mid-life would result in gain, and yet Congress at no time has legislated to deny any part of the depreciation deduction. Clearly the advantage to the taxpayer so specifically provided by Congress should not be taken away or lessened by administrative action. As we shall see, when Congress finally decided to recapture part or all of the advantage so

granted to taxpayers it did so prospectively, specifically and by adjusting the method of taxing the gain on the sale and not by adjusting the deduction for depreciation.

Clearly, then, under the tax law two separate concepts exist: (1) depreciation under Section 167 during the period the asset is used in the business, and (2) recognition of gain or loss under Section 1231 upon disposition of the asset. As noted, the depreciation allowance provided by Section 167 governs in the determination of the period of time over which the taxpayer is permitted to allocate the cost of an asset in the form of annual depreciation deductions. Section 1.167(a)-10(b) of the Treasury Regulations specifies in express terms that this period of cost allocation "shall begin when the asset is placed in service and shall end when the asset is retired from service." Of course an asset is "retired from service" when it is sold. And in Section 1.167(a)-8(a)(1) of the regulations it is stated that when a depreciable asset is "retired from service" by sale, "recognition of gain or loss will be subject to the provisions of Sections 1002, 1231, and other applicable provisions of law." Obviously, Section 167 is not one of the "other applicable provisions of law" to which the provisions refers. The sharp dichotomy in the tax law is therefore clearly recognized by respondent in his own regulations.

The respondent's unequivocal position as stated in his regulations that the period of cost allocation "shall end when the asset is retired from service" is entirely consistent with his practice for over 40 years of allowing depreciation *to the date of sale* in the year of profitable sale. This practice is amply reflected in long-standing judicial precedents and administrative rulings, practice and acquiescence.

In *Eldorado Coal & Mining Co. v. Mayer*, 255 U.S. 522 (1921), this Court sustained an assessment arrived at by "subtracting depreciation and depletion to the date of sale"

of a coal mine in May, 1917, and computing profit on the sale accordingly. Again, in *United States v. Ludey,* 274 U.S. 295 (1927), this Court upheld a determination of gain on the sale of properties computed by deducting depreciation and depletion from March 1, 1913, to the date of their sale in February, 1917 and by making corresponding reductions in the March 1, 1913, basis of the properties to the time of sale. In both of these cases, respondent allowed depreciation on property in the year of its profitable sale and, with the approval of this Court, adjusted the basis of the property for such depreciation in determining the gain on the sale.

The position of the lower courts was just as clear, and they too reflect respondent's long-established practice of allowing depreciation on property in the year of profitable sale. *Beckridge Corp. v. United States,* 129 F.2d 318 (2d Cir. 1942); *Kittredge v. Commissioner,* 88 F.2d 632 (2d Cir. 1937); *Clark Thread Co. v. Commissioner,* 100 F.2d 257 (3d Cir. 1938); *Hall v. United States,* 43 F. Supp. 130 (Ct. Cl.), *cert. denied,* 316 U.S. 664 (1942); *Franklin Lumber & Power Co.,* 18 B.T.A. 1207 (1930), *rev'd on other grounds,* 50 F.2d 1059 (4th Cir. 1931); *Max Eichenberg,* 16 B.T.A. 1368 (1929); *Louis Kalb,* 15 B.T.A. 865 (1929); *Parkersburg & Marietta Sand Co.,* 11 B.T.A. 87 (1928); *Seton Falls Realty Co.,* 6 B.T.A. 883 (1927); *Island Line Shipping Co.,* 4 B.T.A. 1055 (1926); *Capital City Invest. Co.,* 4 B.T.A. 933 (1926); *Cotton Concentration Co.,* 4 B.T.A. 121 (1926); *Walter Frank,* 2 B.T.A. 905 (1925); *Marchetti Roma Cafe Co.,* 2 B.T.A. 529 (1925); *W. W. Carter Co.,* 1 B.T.A. 849 (1925); *Even Realty Co.,* 1 B.T.A. 355 (1925); *Grosvenor Atterbury,* 1 B.T.A. 169 (1924). See also *Thos. Goggan & Bro.,* 45 B.T.A. 218 (1941); *Duncan-Homer Realty Co.,* 6 B.T.A. 730 (1927).

At the urging of respondent, the Board of Tax Appeals expressly held in *Herbert Simons,* 19 B.T.A. 711 (1930), that depreciation had to be computed by the taxpayer in the year

of the profitable sale of depreciable property. In *Wier Long Leaf Lumber Co.,* 9 T.C. 990, 999 (1947), *acq.,* 1948-1 Cum. Bull. 3 (withdrawn), *nonacq.* 1962-1 Cum. Bull. 5, *aff'd and rev'd on other issues,* 173 F.2d 549 (5th Cir. 1949) (the automobile issue), the Tax Court again so held, this time at the insistence of the taxpayer, in the only case up to that point in which respondent had attempted to disallow depreciation in the year of sale. Respondent promptly acquiesced in this adverse decision.[83]

The Court of Appeals for the Eighth Circuit held, in *Forrester Box Co. v. Commissioner,* 123 F.2d 225, 229 (8th Cir. 1941), that a taxpayer who sold machinery and equipment on July 1, 1929, should have "an opportunity to show what the allowable depreciation on the machinery and equipment was from the time it acquired it up to July 1, 1929." And the Third Circuit earlier had held, in *Rieck v. Heiner,* 25 F.2d 453, 454 (3d Cir.), *cert. denied,* 277 U.S. 608 (1928), that "in computing the gain from a sale of property a deduction of depreciation during the period of operation shall be made."

Respondent's long-standing administrative practice was completely consistent with his determinations reflected and approved by the courts in the above cases. In 1920, in O.D. 753, 3 Cum. Bull. 171 (1920), respondent ruled that the sale of plants at a loss did not terminate their "useful life" and did not permit an increased deduction for depreciation for the year of sale. The ruling held that the loss sustained should be deducted as a loss arising from the sale. In 1922, in I.T. 1158, I-1 Cum. Bull. 173 (1922), respondent ruled

[83]Respondent states in the front of every Internal Revenue Bulletin that decisions so acquiesced in should be "relied upon" as "precedents to be used in the disposition of other cases." Acquiescence also furnishes taxpayers assurance that they can rely upon the disposition of the issue "without the danger of being forced to litigate the same question in their own cases." *Stockstrom v. Commissioner,* 190 F.2d 283, 284 (D.C. Cir. 1951).

that depreciation on assets disposed of within any taxable year should be computed for the period from the beginning of the year of sale to the date of sale. Later in that year, in I.T. 1494, I-2 Cum. Bull. 19, 20-21 (1922), respondent approved depreciation of property to $40,000 in the year of sale for $47,000, stating that "The real economic result of every sale of depreciable property is obtained by comparing the sale price with the cost, depreciated to the date of sale." In 1924 (A.R.R. 6930, III-1 Cum. Bull. 45 (1924)) and again in 1927 (G.C.M. 1597, VI-1 Cum. Bull. 71 (1927)), respondent approved depreciation in the year of profitable sale. And in 1928, he published in VII-1 Cum. Bull. 200 (1928) the decision of the Third Circuit in *Rieck v. Heiner, supra.*

In 1948, as pointed out above, respondent published in 1948-1 Cum. Bull. 3 his acquiescence in the decision of the Tax Court in *Wier Long Leaf Lumber Co., supra.*

In 1951, in T.D. 5851, 1951-2 Cum. Bull. 63, respondent amended the income tax regulations to conform them to Section 117(g) of the Internal Revenue Code of 1939 which Congress added to the 1939 Code in 1950. T.D. 5851 incorporated in respondent's regulations (see 1951-2 Cum. Bull. at 73) an example contained in the Conference Report on the Revenue Act of 1950 specifically illustrating the allowance of $500 of depreciation in the year of sale of a facility at a profit of $500. Subsequently, in 1957 respondent issued T D. 6253 1957-2 Cum. Bull. 547, 562-63, which updated the example as part of Section 1.1238-1 of respondent's regulations under the 1954 Code, and the example still was part of the regulations until June 1, 1965, when respondent amended the example in order to eliminate year-of-sale depreciation. T.D. 6825, 1965 Int. Rev. Bull. No. 26, at 6, 30 Fed. Reg. 7281 (1965).

Respondent cannot argue (as erroneously stated by the Eighth Circuit in *United States v. S & A Co.*, 338 F.2d 629,

633 (8th Cir. 1964), *affirming* 218 F. Supp. 677 (D. Minn. 1963), *petition for cert. filed* (No. 862, 1964 Term; renumbered No. 50, 1965 Term)) that prior to 1942 the deduction of depreciation in the year of sale was immaterial because capital gains on the sale of depreciable property were taxed in the same manner as other income. From 1921 to 1934 all taxpayers other than corporate taxpayers were permitted to elect a maximum alternative tax on gain from the sale of capital assets including depreciable property held over two years[84] similar to that now provided by the Code.[85] From 1934 to 1938 those taxpayers were taxed on a varying percentage of such gain, depending on the period held.[86] During this period, corporate taxpayers under some circumstances also might have derived tax benefit from year of sale depreciation. See Vol. 3, 1935 Stand. Fed. Tax Serv. ¶5185, at 6630-31 (Feb. 27, 1935). From 1938 to 1942, no taxpayers were entitled to capital gain treatment on the sales of depreciable property.[87] However, this preferential treatment was reinstated for all taxpayers in 1942.[88] Thus, except for the period 1938 to 1942, it has since 1921 been of potential tax benefit to taxpayers to deduct depreciation in the year of sale and pay a tax on the increased gain which resulted by reason of the dichotomy in the income tax laws which has always existed. Throughout this period, respondent apparently never asserted that year-of-sale depreciation was not

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[84]See Rev. Act of 1921, §206(a)(6), (b); Rev. Acts of 1924 and 1926, §208 (a)(8), (b), (c); Rev. Acts of 1928 and 1932, §101(a), (b), (c)(8).

[85]Int. Rev. Code of 1954, §1201.

[86]See Rev. Acts of 1934 and 1936, §117(a), (b). The percentage of gain recognized varied from 100 percent if the property had been held for less than one year to only 30 percent if the property had been held for over 10 years.

[87]Rev. Act of 1938, §117(a)(1) expressly excluded depreciable property from the definition of "capital asset".

[88]See note 89 *infra* and accompanying text.

deductible (*cf. Duncan-Homer Realty Co.,* 6 B.T.A. 730 (1927)), issued rulings holding that year-of-sale depreciation must be deducted, was sustained by the courts in numerous court cases in reducing basis for depreciation allowable prior to the date of sale, including year-of-sale depreciation, and in the only reported case where the issue as to year-of-sale depreciation was separately raised took the position (contrary to the position taken by the taxpayer because of a peculiar interplay in the alternative tax computations) that year of sale depreciation *must* be deducted. In this position respondent was sustained by the Board of Tax Appeals. *Herbert Simons,* 19 B.T.A. 711 (1930).

F. The lower courts in this case ignored clear indicia of Congressional intent as reflected for more than 20 years.

Considerable evidence of Congressional knowledge of the subject at hand is found in its legislative actions over the past 22 years. In 1942, Congress amended the Internal Revenue Code of 1939 to extend to all taxpayers who sold at a profit depreciable assets used in a trade or business and held for more than six months the favorable tax treatment accorded to long-term capital gain.[89] After 1942 (and with no exceptions until 1951) Congress permitted taxpayers to deduct depreciation in excess of "exhaustion, wear . . . tear . . . [and] obsolescence" in many situations including so-called accelerated depreciation and emergency facility depreciation. For a number of years Congress did not make any provision to limit such depreciation deductions when the asset was sold at mid-life, nor did it make any special adjustments as to the method of taxing the gain on sale even though such gain necessarily resulted even in the absence of any ap-

[89]Int. Rev. Code of 1939, §117(j), added by Rev. Act of 1942, §151(b) (now Int. Rev. Code of 1954, §1231).

preciation in value. In 1947, Congress received a report from the Treasury Department warning against the revenue losses resulting under this provision from sale of assets subject to accelerated depreciation and recommending that, to the extent of the excess of accelerated over normal depreciation, such gains should be treated as ordinary income.[90] However, Congress did not act on this recommendation.

In developing the Revenue Act of 1950, Congress considered the possibility of taxing gains from sales of depreciable assets as ordinary income, but rejected the idea because it presented serious difficulties.[91] However, Congress did enact in that Revenue Act a much more limited restriction on the availability of capital gain treatment for depreciable assets. In connection with the authorization of 60-month amortization of emergency facilities certified as necessary in the interest of national defense,[92] Congress provided that gain from the sale of such facilities should, to the extent that deductions for such amortization exceeded the deduction otherwise allowable for depreciation, be taxed as ordinary income

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[90]*Hearings Before the Committee on Ways and Means, House of Representatives, 80th Cong., 1st Sess. on Revenue Revisions 1947-48, Part 5,* at 3756 (Report of Business Tax Section, Division of Tax Research, Treasury Department).

[91]At the recommendation of the Treasury Department, the House Ways and Means Committee had proposed, in section 209(b) of the House bill (H.R. 8920, 81st Cong., 2d Sess.), that Section 117(j) of the 1939 Code be amended to treat losses on sales of depreciable assets as capital, rather than as ordinary, losses. H.R. Rep. No. 2319, 81st Cong., 2d Sess. 45 (1950). The Senate Finance Committee rejected this change. (S. Rep. No. 2375, 81st Cong., 2d Sess. 51-52 (1950)), and its views prevailed. In the discussion on the floor of the Senate, Senator Milliken, in explaining the Committee's action, stated that "the reverse procedure which involves conforming the treatment of gains to losses and taxing the gains on the sale of section 117(j) assets as ordinary income also presents serious difficulties" and, hence, the "Committee decided that it was best not to change section 117(j) at this time." 96 Cong. Rec. 14057 (1950).

[92]Int. Rev. Code of 1939, §124A, added by Rev. Act of 1950, §216(a) (now Int. Rev. Code of 1954, §168).

instead of capital gain.[93] The Conference Report on this provision contained an example illustrating its operation as follows:[94] an emergency facility acquired on December 31, 1950, for $10,000 was sold on December 31, 1952, for $9,500. Amortization of $4,000 had brought its adjusted basis down to $6,000 *at the date of sale,* while regular depreciation (at $500 a year) *to the date of sale* would have brought the adjusted basis down only to $9,000. Under the amendment, the Committee of Conference stated in its report, $3,000 of the gain would be treated as ordinary income and $500 as long-term capital gain. Obviously, under the Congressional view, had ordinary depreciation been taken, a $500 depreciation deduction was allowable for the year of sale even though the sale price exceeded basis. The same view was until June 1, 1965, reflected in the examples in the Treasury Regulations under this statutory provision.[95]

In considering the Revenue Act of 1951, Congress was again concerned with the availability of capital gain treatment on sales of depreciable property. The Internal Revenue Service had called the attention of Congress to the growing practice of sales of depreciated assets between related taxpayers for the purpose of obtaining a combination of capital gain treatment on the sale and an increased basis for future depreciation purposes.[96] Congress forestalled the continued use of this device by requiring the gain to be treated as ordinary income in the case of sales between an individual and his controlled corporation or between closely related individ-

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[93] Int. Rev. Code of 1939, §117(g)(3), added by Rev. Act of 1950, §216(c) (now INT. REV. CODE OF 1954, §1238).

[94] H.R. REP. No. 3124, 81st Cong., 2d Sess. 29 (1950).

[95] Treas. Reg. §1.1238-1, Examples (1) and (2), amended by T.D. 6825, 1965 Int. Rev. Bull. No. 26, at 6, 30 Fed. Reg. 7281 (1965).

[96] H.R. REP. No. 586, 82d Cong., 1st Sess. 26 (1951).

uals,[97] but again left capital gain treatment otherwise available to sales of depreciable assets and made no effort to adjust the depreciation deduction in the year of sale even though excessive depreciation may have been allowed to the taxpayer.

During the development of the Internal Revenue Code of 1954, Congress again received the recommendation that gains from sales of depreciable assets should be taxed as ordinary income,[98] and again did not adopt it. Congress authorized new rapid depreciation methods in the Internal Revenue Code of 1954,[99] which would normally assume the realization of gain on sale of the asset at mid-life, but reenacted without substantive change the provision authorizing capital gain treatment for profits on sales of depreciable assets.[100]

The President's budget message to the Congress on January 18, 1960, again proposed legislation limiting capital gain treatment on the sale of depreciable business property. Noting that "administration of the depreciation provisions is being hampered by the attempts of some taxpayers to claim excessive depreciation before disposing of their property," the President recommended "that consideration be given to a change in the law which would treat such gain as ordinary income to the extent of the depreciation previously taken on

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[97]Int. Rev. Code of 1939, §117(o), added by Rev. Act of 1951, §328(a) (now Int. Rev. Code of 1954, §1239).

[98]*Hearings Before the Committee on Finance, United States Senate, 83d Cong., 2d Sess. on H.R. 8300, Part 3*, at 1324 (Recommendation No. 180 of American Institute of Accountants).

[99]Int. Rev. Code of 1954, §§ 167(b)(2), (3), and (4).

[100]Int. Rev. Code of 1954, §1231. "This section is derived from section 117 (j) of the present law. There is no substantive change intended. . . ." H.R. Rep. No. 1337, 83d Cong., 2d Sess. A275 (1954). In the floor discussion, Representative Curtis called the attention of the House to the fact that the combination of the new depreciation methods and the capital gain provisions of section 1231 might well "accentuate" already existing capital gain advantages. 100 Cong. Rec. 3678 (1954).

the property."[101] The Secretary of the Treasury, by identical letters dated February 12, 1960, to the Vice President and to the Speaker of the House of Representatives, transmitted to Congress proposed legislation to implement the President's recommendation.[102] In these letters the Secretary of the Treasury said that enactment of the "proposed legislation, by eliminating the opportunity which now exists of converting ordinary income into capital gains, would contribute to the sound administration of the depreciation laws." The President renewed his request in a letter to Congress dated April 20, 1961, in which he made the cogent observation that "the statutory rate of depreciation may not coincide with the actual decline in the value of an asset."[103]

Congress finally adopted a portion of the President's recommendation by providing, in a 1962 amendment to the Internal Revenue Code of 1954, that in the case of dispositions of depreciable personal property in 1963 and later years, gain to the extent of depreciation deductions taken in 1962 and later years would be ordinary income, and the remainder would be capital gain.[104] The Committee Reports on this enactment could not more clearly state the Congressional view that depreciation deductions may exceed the decline in value of the property and that, but for the new provision, this excess is recapturable by the taxpayer at capital gain rates.[105]

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[101] The Budget of the United States Government for the Fiscal Year Ending June 30, 1961, at M11.

[102] Treasury Department Release A-761, dated February 15, 1960.

[103] The letter is reprinted in *Hearings Before the Committee on Ways and Means, House of Representatives, on the President's 1961 Tax Recommendations* (H.R. Doc. No. 140, 87th Cong., 1st Sess.), vol. 1, at 13. The testimony of the Secretary of the Treasury on this recommendation is recorded at pages 44-45 of those *Hearings*.

[104] Int. Rev. Code of 1954, §1245, added by Rev. Act of 1962, §13(a).

[105] H.R. Rep. No. 1447, 87th Cong., 2d Sess. 66-67 (1962); S. Rep. No. 1881, 87th Cong., 2d Sess. 95 (1962).

In 1963, the Administration renewed its request that similar treatment be accorded to gain on the disposition of depreciable real property.[106] And in a 1964 amendment to the Internal Revenue Code of 1954,[107] Congress provided (with certain modifications) that gain from dispositions in 1964 and later years of depreciable real property (but limited generally to real property held for less than 10 years) should be treated as ordinary income to the extent that the gain is equal to or less than post-1963 depreciation, and as capital gain to the extent that the gain exceeds such depreciation.[108]

In neither 1962 nor 1964 did Congress make any attack on the depreciation deduction as such. Thus, for more than 20 years Congress has been aware that accelerated depreciation in excess of "exhaustion, wear . . . tear . . . [and] obsolescence" was being deducted and that depreciation was being allowed in the year of profitable sale, and until 1962 it made no attempt to limit such deductions, and then the problem was approached entirely through a change in the nature of the gain realized and *not* through an adjustment of the depreciable deduction. The fact that in the 1962 amendment pertaining to dispositions of depreciable personal property it limited the application of the amendment to post-1961 depreciation deductions allowed on the prop-

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[106] *Statement of Secretary of the Treasury Before the Committee on Ways and Means, House of Representatives, on the President's Special Message on Tax Reduction and Reform, on February 6, 1963*, at 25.

[107] Int. Rev. Code of 1954, §1250, added by Rev. Act of 1964, §231(a).

[108] The portion of the gain taxable as ordinary income is a percentage of the excess of post-1963 depreciation deductions over straight-line depreciation. The percentage is 100 percent for the first 20 full months the property is held and decreases 1 percent per month thereafter until the gain is 100 percent capital gain at the end of 10 years. INT. REV. CODE OF 1954, §§ 1250(a)(1), (2) and 1250(b)(1). The Committee Reports with respect to this legislation for the first time indicate an awareness by Congress of the controversy exemplified by this litigation, and Congress in effect took a neutral attitude. See H.R. REP. No. 749, 88th Cong., 1st Sess. 103 (1964); S. REP. No. 830, 88th Cong., 2d Sess. 133 (1964).

erty, and the added fact that in the 1964 amendment pertaining to dispositions of depreciable real property Congress limited the application of the amendment to post-1963 depreciation deductions allowed on property held for less than 10 years, suggest Congressional cognizance of the interrelationship of the depreciation and capital gain provisions and its awareness of depreciation patterns which can fairly be changed only prospectively.

The lack of correlation between market value and depreciated cost was specifically brought before Congress on three occasions prior to the adoption of the 1954 Code, and in 1950,[109] Congress, in dealing with the general problem, specifically recognized the deductibility of depreciation in the year of sale. This recognition was found in respondent's Treasury Regulations until June 1, 1965, was otherwise consistent with respondent's practice until June 7, 1962 (the day before the trial of this case) when respondent announced his new position that he no longer would allow depreciation in the year of profitable sale of an asset,[110] and is reflected in a long series of judicial decisions, including *Wier Long Leaf Lumber Co.* in which respondent had acquiesced for 14 years until June 25, 1962 (one week after the taxpayer had instituted suit in the *S & A Co.* case) when such acquiescence was withdrawn.[111] Under these circumstances, when Congress reenacted the depreciation provision of the income tax law at the time it adopted the 1954 Code, it in effect approved the interpretation of those provisions as found in the existing judicial interpretation and administrative regulations and rulings issued by respondent, which thereby acquired the

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[109]See note 94 *supra* and accompanying text.

[110]Treasury Information Release 374, dated June 7, 1962, reissued as Rev. Rul. 62-92, 1962-1 Cum. Bull. 29.

[111]1962-1 Cum. Bull. 5.

force of law. *Cammarano v. United States,* 358 U.S. 498, 509-12 (1959); *Hecht v. Malley,* 265 U.S. 144 (1924); 1 SUTHERLAND, STATUTORY CONSTRUCTION ¶1935 (3d Ed. 1943). See also *Commissioner v. Brown,* ---- U.S. ----, CCH 1965 Stand. Fed. Tax Rep. (65 U.S. Tax Cas.) ¶9375, at 95,343 (Apr. 27, 1965). This is particularly true in the light of the *specific,* as opposed to the inferred, consideration given by Congress to the problem. See *Commissioner v. P. G. Lake, Inc.,* 356 U.S. 260 (1958); *United States v. Calamaro,* 354 U.S. 351 (1957); *Commissioner v. Glenshaw Glass Co.,* 348 U.S. 426 (1955).

It could not be clearer that respondent, failing since 1942 to persuade Congress to change the tax laws in order to correct so-called "abuses" resulting from favored capital gains treatment accorded taxpayers on the disposition of depreciable assets, took it upon himself to change the law administratively, in utter disregard of all precedent and principle.

G. The theory adopted by the lower courts in this case has been thoroughly discredited by the overwhelming weight of contemporary court decisions.

The most comprehensive judicial discussion and analysis of the application to the issue involved in this case of the well-settled principles discussed in this brief are found in the opinion of the Court of Appeals for the Eighth Circuit in *S & A Co. v. United States,* 218 F. Supp. 677 (D. Minn. 1963), *aff'd,* 338 F.2d 629 (8th Cir. 1964), *petition for cert. filed* (No. 862, 1964 Term; renumbered No. 50, 1965 Term). In the *S & A Co.* case, the facts were undisputed: the taxpayer used a taxable year ending August 31, and on April 1, 1956, sold all of its operating assets as part of the sale of its going business, which was the manufacture and sale of outboard motors. The purchaser acquired the taxpayer's business for the purpose of conducting the same business at

the same location and with substantially the same employees, and it in fact did so. Included in the assets sold were depreciable assets, and the portion of the total sale price allocated to such assets not only exceeded the undepreciated basis of the assets as of September 1, 1955, but also exceeded the original cost of such assets as well. On taxpayer's tax return for its taxable year ending August 31, 1956, the taxpayer claimed depreciation of $125,481.77 with respect to the depreciable assets for the period September 1, 1955, to April 1, 1956. The taxpayer's computation of this claimed deduction for depreciation was based upon the rates of depreciation claimed by the tax year and allowed by respondent with respect to such assets on taxpayer's prior returns. There was no dispute that the claimed deduction for depreciation of $125,481.77 was a "reasonable allowance" for depreciation for the period September 1, 1955, to April 1, 1956, with respect to the assets sold on the latter date, unless the sale in and of itself created a reason for changing the depreciation allowance.

Respondent disallowed the claimed depreciation for the year of sale only, but did not challenge the taxpayer's estimates of "useful life" or "salvage value", nor did he challenge depreciation claimed in prior open years. The district court found the following facts (in addition to those summarized above): at the times when the taxpayer acquired the depreciable assets which it sold on April 1, 1956, and at all times prior to the sale, the taxpayer intended to use such assets in the business for the full duration of their economic or physical life; at the times when the taxpayer acquired the depreciable assets in question, it estimated the period of usefulness of such assets in the business to be the full duration of their economic or physical life; at the time when the taxpayer acquired such assets and at all times prior to the sale, taxpayer's expectation that such assets would be useful

in the business for the full duration of their economic or physical life was reasonable and wholly consistent with its experience with these and similar assets used in its business; from the times when the taxpayer acquired such assets until the time of sale, the experience of the taxpayer with respect to these and similar assets was wholly consistent with and reflected taxpayer's expectation and intention of using such assets in the business for the full duration of their economic or physical life; at no time prior to the sale of such assets, did the taxpayer have a predetermined plan to sell or otherwise dispose of such assets prior to the expiration of the full duration of their economic or physical life; the "useful life" in the business of the depreciable assets did not end or change on or before August 31, 1956; and as of April 1, 1956, the depreciable assets sold on that date had an average estimated remaining "useful life" in the business of approximately 10 years.

On the basis of these findings, the district court distinguished this Court's decisions in *Massey* and *Hertz* and the Sixth Circuit's decision in *Cohn* and concluded that the amount of the total sale price realized by the taxpayer on the sale of its assets on April 1, 1956, which was allocated by the taxpayer to the depreciable assets sold on that date, merely reflected the market value of such depreciable assets at a particular point of time prior to the end of the "useful life" of such assets in the business; that the excess of such portion of the total sale price allocated to such depreciable assets over the undepreciated cost of such assets on September 1, 1955, constituted mere appreciation in value; and that the amount of the total sale price allocated by the taxpayer to such depreciable assets did not determine or reflect the "salvage value" of such assets. Accordingly, the district court upheld the taxpayer's claimed deduction for year-of-

sale depreciation. The Government appealed this adverse decision to the Eighth Circuit.

The Eighth Circuit affirmed the decision of the district court. The Court exhaustively reviewed the fundamental concepts of depreciation accounting for income tax purposes, the long-standing judicial precedents, administrative rulings, practice, and acquiescence, repeated statutory reenactments, and the pertinent provisions of the tax statute and the Treasury Regulations. Applying the principles established by these authorities, the Eighth Circuit turned to the facts before it and made the following observations:[112]

> 1. The facts here possess impressive strength. The taxpayer's sale of its outboard motor assets was a sale of a going business. It acquired those assets and continued to hold them with, at all times, the intent to keep and utilize them in its business until the end of their economic life. It did not intend to dispose of them in the midst of that life and it had established no practice of early disposal, as was the situation in both Massey and Hertz. No challenge is made as to the correctness of the acquisition estimates of useful life and salvage value at the end of that life. The Commissioner accepted these estimates for all prior tax years and would have accepted them for fiscal 1956 had the sale not taken place in that year.
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> 6. With no dispute here as to either cost or useful life, the case hinges on salvage value. But this is to be determined, not at the time of the asset's retirement, but at the time of acquisition. . . .
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> 7. There is no absolute identity of salvage value with sales price. The one is not necessarily equivalent to the other. Neither the statute nor the regulations equate them or make an exception out of the sale year. The emphasis, as has been noted, is, instead, on the estimate of salvage value, on such estimate at acquisition, on rede-

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[112] 338 F.2d at 639-43.

termination as the exception, on the distinct possibility of gain or loss on disposition, and on divorcement of salvage value from price level fluctuations.

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10. On the facts before us those provisions of Reg. §1.167(b)-(0)(a) which deny depreciation beyond cost less salvage value and which determine the reasonableness of a claim for depreciation upon "conditions known to exist at the end of the period" do not defeat this taxpayer's claim for depreciation. Of course, a favorable sale price might, in some instances, be a factor indicative of acquisition-estimate error. But this is not necessarily so and, it seems to us, is distinctly not so where, as in this case, there has been and still is no challenge as to cost and as to the useful life and salvage value acquisition estimates. The propriety of all three factors is accepted. The lack of challenge to the taxpayer's claimed and parallel depreciation deductions in prior tax years which were still open for audit adjustment is a concession to their propriety.

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11. This is not a situation where the assets are sold at or near the very end of useful life in the taxpayer's hands. . . .

12. We have here, instead, an unanticipated sale in midlife. This record contains nothing which discloses any change in the economic life of the assets. The sale itself did not change this.

13. There is a logical inconsistency in the government's attack on year-of-sale depreciation and its allowance of the depreciation in preceding years still open for adjustment when the sale facts became known to the government. . . .

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15. The government's position seems to emphasize hindsight and to abandon the concept that depreciation rests on prospective estimates which, to be sure, must be reasonable. It would, to use Judge Blumenfeld's words in Motorlease, p. 363 of 215 F. Supp., "set up an automatic hindsight re-evaluation which becomes a self-

executing redetermination of salvage value triggered by the sale of depreciable assets".

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19. We have deep respect for the conclusions reached by the Second Circuit majorities in Fribourg and Motorlease. But we cannot escape the feeling that the results in those cases underestimate both the law's dichotomy of approach to depreciation and to capital gain and, as well, the fact distinction, . . . so inherent in Cohn, between an intended sale of depreciable assets at or near the end of useful life and an unanticipated sale in mid-life. . . .

On the basis of the foregoing, the Eighth Circuit concluded:[113]

After earnest consideration of all the arguments which have been advanced upon us by the contending parties, we reach the conclusion that, on the facts here presented —unanticipated and noncustomary sale in mid-life of a depreciable asset; acceptance of the correctness and reasonableness of the taxpayer's acquisition estimates of useful life and salvage value; actual approval of depreciation based on these estimated in prior years, some of which still remained open; and the inescapable inference that the claimed depreciation would have been allowed for the sale year had the sale not taken place— the taxpayer has sustained its burden of proof and is entitled to the deduction. . . .

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[113] *Id.* at 639.

In recent years, in addition to the Eighth Circuit, the Tax Court[114] (except for a brief period of departure[115]), and the federal district courts[116] (with one exception[117]), have uniformly applied the well-established principles of depreciation accounting developed and followed in a long line of ju-

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[114]Engineers Ltd. Pipeline Co., 44 T.C. ___ No. 25, CCH Tax Ct. Rep., Dec. 27,411 (May 28, 1965); L. M. Lockhart, 43 T.C. 776 (1965), on appeal to Ninth Circuit; Bell Lines, Inc., 43 T.C. 358 (1964); Holder Driv-Ur-Self, Inc., 43 T.C. 202 (1964), *nonacq.*, 1965 Int. Rev. Bull. No. 30, at 6; Harry Trotz, 43 T.C. 127 (1964), on appeal to Tenth Circuit; Smith Leasing Co., Inc., 43 T.C. 37 (1964), on appeal to Fifth Circuit; Macabe Co., Inc., 42 T.C. 1105 (1964), on appeal to Ninth Circuit; Herschel M. Hays, CCH Tax Ct. Mem. 1965-213, 24 CCH Tax Ct. Mem. 1103 (Aug. 9, 1965); Specialty Paper & Board Co., CCH Tax Ct. Mem. 1965-208, 24 CCH Tax Ct. Mem. 1085 (July 28, 1965); W. Lawrence Oliver, CCH Tax Ct. Mem. 1965-83, 24 CCH Tax Ct. Mem. 438 (Apr. 7, 1965); The Covered Wagon, Inc., CCH Tax Ct. Mem. 1965-79, 24 CCH Tax Ct. Mem. 427 (Apr. 5, 1965); Harry Friend, CCH Tax Ct. Mem. 1965-35, 24 CCH Tax Ct. Mem. 192 (Feb. 23, 1965), on appeal to Fourth Circuit; Melvon C. Miller, 23 CCH Tax Ct. Mem. 1866 (1964); Moses Lake Homes, Inc., 23 CCH Tax Ct. Mem. 1756 (1964); Palmaneda Adams, 23 CCH Tax Ct. Mem. 1743 (1964), on appeal to Sixth Circuit.

[115]Randolph D. Rouse, 39 T.C. 70 (1962), *overruled*, Macabe Co., Inc., 42 T.C. 1105 (1964); Contra Costa Trucking Co., 22 CCH Tax Ct. Mem. 1018 (1963); Fribourg Navigation Co., Inc., 21 CCH Tax Ct. Mem. 1533 (1962), *aff'd*, 335 F.2d 15 (2d Cir. 1964), *cert. granted*, ___ U.S. ___ (No. 679, 1964 Term; renumbered No. 23, 1965 Term). Inasmuch as the Tax Court, in deciding *Contra Costa Trucking Co.* and this case, considered its prior decision in *Rouse* as dispositive of the issue before it, it would appear that the necessary effect of the Tax Court's overruling of its decision in *Rouse* would be implicit repudiation of its prior decisions in *Contra Costa Trucking Co.* and this case.

[116]Mountain States Mixed Feed Co. v. United States, ___ F. Supp. ___, CCH 1965 Stand. Fed. Tax Rep. (65-2 U.S. Tax Cas.) ¶ 9551 (D. Colo. May 26, 1965); R. A. Heintz Constr. Co. v. United States, ___ F. Supp. ___, CCH Stand. Fed. Tax Rep. (65-2 U.S. Tax Cas.) ¶ 9455 (D. Ore. Mar. 25, 1965); Occidental Loan Co. v. United States, 235 F. Supp. 519 (S.D. Calif. 1964), on appeal to Ninth Circuit; Wyoming Builders, Inc. v. United States, 227 F. Supp. 534 (D. Wyo. 1964), on appeal to Tenth Circuit; S & A Co. v. United States, 218 F. Supp. 677 (D. Minn. 1963), *aff'd*, 338 F.2d 629 (8th Cir. 1964), *petition for cert. filed* (No. 862, 1964 Term; renumbered No. 50, 1965 Term); The Motorlease Corp. v. United States, 215 F. Supp. 356 (D. Conn. 1963), *rev'd*, 334 F.2d 617 (2d Cir. 1964), *petition for cert. filed* (No. 685, 1964 Term; renumbered No. 24, 1965 Term); Kimball Gas Prods. Co. v. United States, ___ F. Supp. ___, CCH 1963 Stand. Fed. Tax Rep. (63-2 U.S. Tax Cas.) ¶ 9507 (W.D. Tex. Nov. 3, 1962), on appeal to Fifth Circuit.

[117]Killebrew v. United States, 234 F. Supp. 481 (D. Tenn. 1964), on appeal to Sixth Circuit.

dicial, administrative, and accounting precedents and recognized in repeated statutory reenactment, and have flatly rejected respondent's new theory as a radical departure from these precedents. The Court of Appeals for the Second Circuit now stands alone (except for one district court opinion) in its acceptance of respondent's new theory, a theory which is no longer accepted even by the Tax Court whose decision the Court of Appeals affirmed in this case.[118]

CONCLUSION

In the light of the principles discussed in this brief which are embodied in the basic statutory provision and which have been recognized by the courts, respondent, and well-established accounting practice, it becomes apparent that the question as to the allowability of a deduction for depreciation in the year of profitable sale turns on evidentiary matters. In order to sustain his claimed deduction for depreciation in the year of profitable sale, or in any other year for that matter, the taxpayer has the burden of proving that his acquisition-time estimates of "useful life" and "salvage value" were reasonable. If the taxpayer does not carry this burden of proof, the trier of fact would be justified in concluding that the taxpayer's claimed deductions for depreciation in all years, *not* merely the year of sale, were excessive. On the other hand, once the taxpayer has carried his burden of proof on the reasonableness of his acquisition-time estimates, it follows that the trier of fact would be justified in concluding only that, as a matter of law, the claimed deductions for depreciation in *all* years, including the year of sale, were reasonable and therefore allowable. Obviously, when, as in this case, re-

[118]See note 115 *supra*. Moreover, in a fully reviewed opinion in Macabe Co., Inc., 42 T.C. 1105, 1110 (1964), the Tax Court expressed its disagreement "with the rationale relied upon by a majority of the panel [of the Court of Appeals for the Second Circuit] which decided" *Fribourg*.

spondent has conceded not only that the acquisition-time estimates of "useful life" and "salvage value" were reasonable, but also that the claimed deduction for depreciation in the year of sale is reasonable and allowable but for the sole fact of the unanticipated sale, it follows that the respondent has conceded himself out of court.

Against respondent's "prior long-standing and consistent interpretation"—as repeatedly reflected and approved in decisions of this Court and many lower courts—his "more recent *ad hoc* contention as to how the statute should be interpreted cannot stand." *United States v. Leslie Salt Co.*, 350 U.S. 383, 396 (1956). A principle so thoroughly established by the vast body of precedents and by repeated statutory reenactment should not be overturned at this late date except by legislative revision. As a majority of this Court recently has observed, it would be "wise to leave to the Congress the fashioning of a rule which, in any event, must have wide ramifications." *Commissioner v. Brown*, ___ U.S. ___, CCH 1965 Stand. Fed. Tax Rep. (65 U.S. Tax Cas.) ¶9375, at 95,343 (Apr. 27, 1965), quoting *American Automobile Ass'n v. United States*, 367 U.S. 687, 697 (1961).

For the foregoing reasons, the decision of the majority of the Court of Appeals in this case should be reversed by this Court.

Respectfully submitted,

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APPENDIX

Treasury Regulations*

§1.167(a)-1 Depreciation In General. — (a) *Reasonable allowance.* — Section 167(a) provides that a reasonable allowance for the exhaustion, wear and tear, and obsolescence of property used in the trade or business or of property held by the taxpayer for the production of income shall be allowed as a depreciation deduction. The allowance is that amount which should be set aside for the taxable year in accordance with a reasonably consistent plan (not necessarily at a uniform rate), so that the aggregate of the amounts set aside, plus the salvage value, will, at the end of the estimated useful life of the depreciable property, equal the cost or other basis of the property as provided in section 167(f) and §1.167(f)-1. An asset shall not be depreciated below a reasonable salvage value under any method of computing depreciation. See paragraph (c) below for definition of salvage. The allowance shall not reflect amounts representing a mere reduction in market value.

(b) *Useful life.*—For the purpose of section 167 the estimated useful life of an asset is not necessarily the useful life inherent in the asset but is the period over which the asset may reasonably be expected to be useful to the taxpayer in his trade or business or in the production of his income. This period shall be determined by reference to his experience with similar property taking into account present conditions and probable future developments. Some of the factors to be considered in determining this period are (1) wear and tear and decay or decline from natural causes, (2) the normal progress of the art, economic changes, inventions,

*As in effect during the calendar years 1956 and 1957.

and current developments within the industry and the taxpayer's trade or business, (3) the climatic and other local conditions peculiar to the taxpayer's trade or business, and (4) the taxpayer's policy as to repairs, renewals, and replacements. Salvage value is not a factor for the purpose of determining useful life. If the taxpayer's experience is inadequate, the general experience in the industry may be used until such time as the taxpayer's own experience forms an adequate basis for making the determination. The estimated remaining useful life may be subject to modification by reason of conditions known to exist at the end of the taxable year and shall be redetermined when necessary regardless of the method of computing depreciation. However, estimated remaining useful life shall be redetermined only when the change in the useful life is significant and there is a clear and convincing basis for the redetermination. For rules covering agreements with respect to useful life, see section 167(d) and §1.167(d)-1.

(c) *Salvage.*—Salvage value is the amount (*determined at the time of acquisition*) *which is estimated will be* realizable upon sale or other disposition of an asset when it is no longer useful in the taxpayer's trade or business or in the production of his income and is to be retired from service by the taxpayer. *Salvage value shall not be changed at any time after the determination made at the time of acquisition merely because of changes in price levels. However, if there is a redetermination of useful life under the rules of paragraph (b), salvage value may be redetermined based upon facts known at the time of such redetermination of useful life.* Salvage, when reduced by the cost of removal, is referred to as net salvage. The time at which an asset is retired from service may vary according to the policy of the taxpayer. If the taxpayer's policy is to dispose of assets which are still in good operating condition, the salvage value

may represent a relatively large proportion of the original basis of the asset. However, if the taxpayer customarily uses an asset until its inherent useful life has been substantially exhausted, salvage value may represent no more than junk value. Salvage value must be taken into account in determining the depreciation deduction either by a reduction of the amount subject to depreciation or by a reduction in the rate of depreciation, but in no event shall an asset (or an account) be depreciated below a reasonable salvage value. See, however, §1.167(b)-2(a) for the treatment of salvage under the declining balance method. The taxpayer may use either salvage or net salvage in determining depreciation allowances but such practice must be consistently followed and the treatment of the costs of removal must be consistent with the practice adopted. For specific treatment of salvage value see §§1.167(b)-1, 2, and 3. When an asset is retired or disposed of, appropriate adjustments shall be made in the asset and depreciation reserve accounts. For example, the amount of the salvage adjusted for the costs of removal may be credited to the depreciation reserve. [Italics supplied.]

* * *

§1.167(a)-8. Retirements. (a) *Gains and losses on retirements.* For the purposes of this section the term "retirement" means the permanent withdrawal of depreciable property from use in the trade or business or in the production of income. The withdrawal may be made in one of several ways. For example, the withdrawal may be made by selling or exchanging the asset, or by actual abandonment. In addition, the asset may be withdrawn from such productive use without disposition as, for example, by being placed in a supplies or scrap account. The tax consequences of a retirement depend upon the form of the transaction, the reason therefor, the timing of the retirement, the estimated useful

life used in computing depreciation, and whether the asset is accounted for in a separate or multiple asset account. Upon the retirement of assets, the rules in this section apply in determining whether gain or loss will be recognized, the amount of such gain or loss, and the basis for determining gain or loss:

(1) Where an asset is retired by sale at arm's length, recognition of gain or loss will be subject to the provisions of sections 1002, 1231, and other applicable provisions of law.

* * *

§1.167(a)-9 Obsolescence. — The depreciation allowance includes an allowance for normal obsolescence which should be taken into account to the extent that the expected useful life of property will be shortened by reason thereof. Obsolescence may render an asset economically useless to the taxpayer regardless of its physical condition. Obsolescence is attributable to many causes, including technological improvements and reasonably foreseeable economic changes. Among these causes are normal progress of the arts and sciences, supercession or inadequacy brought about by developments in the industry, products, methods, markets, sources of supply, and other like changes, and legislative or regulatory action. In any case in which the taxpayer shows that the estimated useful life previously used should be shortened by reason of obsolescence greater than had been assumed in computing such estimated useful life, a change to a new and shorter estimated useful life computed in accordance with such showing will be permitted. No such change will be permitted merely because in the unsupported opinion of the taxpayer the property may become obsolete. For rules governing the allowance of a loss when the usefulness of an asset is suddenly terminated, see section 165 and the regulations thereunder. If the estimated useful life and the depre-

ciation rates have been the subject of a previous agreement, see section 167(d) and §1.167(d)-1.

§1.167(a)-10 When Depreciation Deduction Is Allowable. —(a) A taxpayer should deduct the proper depreciable allowance each year and may not increase his depreciation allowances in later years by reason of his failure to deduct any depreciation allowance or of his action in deducting an allowance plainly inadequate under the known facts in prior years. The inadequacy of the depreciation allowance for property in prior years shall be determined on the basis of the allowable method of depreciation used by the taxpayer for such property or under the straight line method if no allowance has ever been claimed for such property. The preceding sentence shall not be construed as precluding application of any method provided in section 167(b) if taxpayer's failure to claim any allowance for depreciation was due solely to erroneously treating as a deductible expense an item properly chargeable to capital account. For rules relating to adjustments to basis, see section 1016 and the regulations thereunder.

(b) The period for depreciation of an asset shall begin when the asset is placed in service and shall end when the asset is retired from service. A proportionate part of one year's depreciation is allowable for that part of the first and last year during which the asset was in service. . . .

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1965

No. 23

FRIBOURG NAVIGATION COMPANY, INC.,
Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

ON WRIT OF CERTIORARI TO THE UNITED STATES
COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR THE PETITIONER

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TABLE OF CONTENTS

TABLE OF CITATIONS

CASES:

PAGE

PAGE

MISCELLANEOUS:

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OCTOBER TERM, 1965

FRIBOURG NAVIGATION COMPANY, INC., *Petitioner*, *v.* COMMISSIONER OF INTERNAL REVENUE, *Respondent*.	No. 23

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR THE PETITIONER

Opinions Below

The opinion of the Court of Appeals (R. 76-82), Judge Moore dissenting (R. 82-90), is reported at 335 F. 2d 15 (2d Cir. 1964). The memorandum opinion of the Tax Court (R. 2-18), T. C. Memo. 1962-290, is not officially reported, but is unofficially reported at 21 CCH T. C. Memo. 1533 (1962) and at 1962 P-H T. C. Memo. ¶ 62,290.

Jurisdiction

The judgment of the Court of Appeals was entered on July 15, 1964. (R. 91.) An order of the Court of Appeals denying a timely petition for rehearing and granting a timely motion to stay issuance of its mandate was entered on August 20, 1964. (R. 99-100.) The petition for a writ of certiorari was filed on November 13, 1964, and was granted on February 1, 1965. (R. 102.) The jurisdiction of this Court is invoked under 28 U. S. C. § 1254(1).

Statute and Regulations Involved

The statute and regulations involved are section 167 of the Internal Revenue Code of 1954, 26 U. S. C. § 167, and Treasury Regulations sections 1.167(a)-1 through 1.167(i)-1, 26 C. F. R. §§ 1.167(a)-1 through 1.167(i)-1. The pertinent portions of the statute and regulations are set forth in Appendix A, *infra* pp. 1a-11a.

Question Presented

Whether, as a matter of law, the sale of depreciable property for an amount in excess of its depreciated cost at the beginning of the year of sale necessarily bars the deduction of depreciation on the property for the period of its use during that year.

Statement of the Case

The facts of this case are not in dispute. Petitioner, a Delaware corporation organized in 1946, was engaged during and prior to 1957 in the business of owning and operating ships for charter to others for the carriage of dry, bulk cargoes in foreign commerce. (R. 3, 19.) On December 21, 1955, petitioner purchased the *S.S. Joseph Feuer* (the "*Feuer*"), a Liberty-type dry cargo ship, from an unrelated party for $469,000. (R. 4, 20.) The *Feuer* had been built during 1943, under an accelerated ship-building program, for emergency use during World War II. (R. 4, 49.)

Liberty-type ships had a speed of only 10 knots, old-fashioned engines, inefficient cargo loading and discharging equipment, and a low ratio of cubic capacity to dead weight. (R. 8, 49-50.) They were greatly inferior to modern, postwar cargo ships, which had a speed of 14 to 18 knots, turbine engines, better cargo handling facilities and a much larger cubic capacity. (R. 8, 49-50.) In postwar com-

merce, Liberty-type ships were reduced principally to the shipment of low-paying bulk commodities, primarily grain and coal. (R. 8-11, 50.)

The *Feuer* as an American flag ship was unable, because of higher operating costs, to compete with foreign flag vessels in general commerce. (R. 31.) The only cargoes it could economically carry were the bulk commodities shipped abroad under United States foreign aid legislation, which gave American flag vessels a preferred status. (R. 31-34.) On completion of such shipments the *Feuer* returned to the United States in ballast because rates for return cargoes were too low to permit it to operate profitably. (R. 31-32, 35.) Petitioner was prohibited by law from transferring the *Feuer* to a foreign flag. (R. 31.)

Petitioner operated the *Feuer* under the American flag as a tramp ship, for charter wherever cargo was offered. (R. 7, 20, 28.) It operated the *Feuer* under six voyage charters for shipment of grain, sugar, fertilizer or scrap iron from the United States or Cuba to Korea, Japan, Morocco, Egypt, Israel or India, and also operated it under time charter for about nine months. (R. 7, 20-21.)

In the fall of 1956, following the outbreak of hostilities, the Suez Canal was blocked by sunken vessels and was not reopened for full-time use, under Egyptian management, until March 29, 1957. (R. 5.) Because of the blockage of the Suez Canal, which is the busiest interocean canal in the world, ships had to take longer routes to places usually reached by going through the Canal. (R. 5.) There was a resulting scarcity of available ships to carry cargoes. (R. 5.) European governments, anticipating a long delay in the opening of the Canal, began stockpiling oil and other commodities. (R. 5.) There were resulting increases in charter rates, which reached a peak in January and February of 1957. (R. 5.) During this brief crisis the opera-

tion of any type of ocean-going vessel, including American flag Liberty-type ships, became profitable. (R. 5, 57.) The temporary scarcity of ships caused sales prices of ships to rise sharply. (R. 5.) In January and February of 1957, purchasers were willing to pay $1,000,000 for American flag Liberty-type ships. (R. 5.)

Petitioner did not follow a practice of buying ships and then selling them after a short period of use. (R. 6.) However, in June of 1957, the president of Isbrandtsen Company, Inc. ("Isbrandtsen") approached petitioner about the possible purchase of the *Feuer*. (R. 6.) Isbrandtsen, like petitioner, was engaged in the business of using Liberty-type ships as tramp carriers of grain and other bulk commodities. (R. 6, 52.) Petitioner had not put the *Feuer* up for sale, but Isbrandtsen offered such an excellent price for the *Feuer* that petitioner decided to sell it. (R. 6.) On June 14, 1957, petitioner entered into a contract for the sale of the *Feuer* to Isbrandtsen in December of that year for $700,000. (R. 6.) At the closing on December 23, 1957, the sales price was reduced to $695,500 in connection with a change in financing. (R. 6.)

Prior to the sale petitioner adopted a plan of complete liquidation, which it completed within 12 months in accordance with section 337 of the Internal Revenue Code. (R. 7.) Petitioner owned and operated another ship, the *Flying Foam,* which it distributed in kind in the complete liquidation. (R. 6, 7.)

By December of 1957, when petitioner delivered the *Feuer* to Isbrandtsen, charter rates had fallen sharply from the high levels they had reached during the Suez crisis. (R. 8.) This drop in rates resulted from the reopening of the Suez Canal, the diminishing of world tension, the entry into the market of large modern vessels and the realization by the European governments that they had overstocked commodities. (R. 8.) By the end of 1957, the eco-

nomic position of the remaining American flag Liberty-type ships had deteriorated substantially. (R. 8-11.) Charter rates for American flag Liberty-type ships were significantly lower than they had been in the last quarter of 1955 when petitioner had purchased the *Feuer*. (R. 9.) This decline in charter rates brought about a corresponding decline in prices of Liberty-type ships, which by December 1957 had fallen to the level of $400,000 to $500,000. (R. 11.)

The business of shipping coal, which had been one of the two principal commodities carried by American flag Liberty-type ships, had largely disappeared by the end of 1957 because of the world-wide increase in oil consumption. (R. 10.) At the same time, the trade in heavy grain, which was the last important commodity carried by the American flag Liberty-type ships, was beginning to be captured by faster and larger converted tankers, which were able to carry grain at much lower rates. (R. 8, 10.) During the Suez crisis the United States Government had encouraged the building of American flag tankers by providing extensive financing guarantees. (R. 10.) During 1957, nineteen American flag tankers having a total dead weight tonnage of 731,273 tons (about equal to the total dead weight tonnage of the 70 or so Liberty-type ships operating as tramp vessels under the American flag) were contracted for or under construction. (R. 10.) These tankers had speeds of about 15½ to 16 knots, much faster than the Liberty-type ships. (R. 10.) During the Suez crisis, when these tankers were ordered, the charter rates for oil were high and remunerative. (R. 10.) However, by the end of 1957 this was no longer true, and the surplus American flag tankers had begun to be converted to the shipment of grain in competition with Liberty-type ships. (R. 10.)

In December 1957 the United States Maritime Administration sold several Liberty-type ships for scrapping

under a previously extended invitation for bids. (R. 11.) The price obtainable for Liberty-type ships for scrapping is determined principally by reference to the price of No. 1 scrap steel, and the cost of preparation, towing, insurance, and other costs of scrapping. (R. 11.) A buyer for scrapping is influenced by the estimated future of the scrap steel market because of the time required to prepare and sell the scrap steel. (R. 11.) In December of 1957, scrap steel prices were falling. (R. 11.) The amount which a buyer could be expected to offer for a Liberty-type ship for scrapping at that time was between \$53,000 and \$60,000. (R. 11.)

Before buying the *Feuer* (then named the *S. S. Albion*), petitioner applied for a ruling from the Engineering and Valuation Branch of the Internal Revenue Service with respect to depreciation of the ship. (R. 4, 20.) The Internal Revenue Service ruled, by letter dated December 8, 1955, that it would accept for the *Feuer* a useful economic life of three years from the date of acquisition and a salvage value computed on the basis of \$5 per dead weight ton (\$54,000). (R. 4; Ex. 4-D, R. 22, 24-25.) The ruling also stated that the cost of \$469,000, less such salvage value, should be spread ratably over such three-year period; that the cost would be subject to verification; that the estimated remaining useful life was subject to such change as subsequent experience might warrant; and that the ruling was not to be construed as a binding agreement as to useful life within section 167(d) of the Internal Revenue Code. (R. 4; Ex. 4-D, R. 22, 24-25.)

Acting in accordance with the ruling, petitioner computed depreciation of the *Feuer* on the basis of \$415,000 (\$469,000 cost less \$54,000 salvage value), which it spread over a three-year useful life from December 21, 1955, under the straight-line method. (R. 4.) This resulted in deprecia-

tion at a daily rate of about \$378.65. (R. 4.) Petitioner claimed the following depreciation deductions at such rate and under such method, as authorized by the ruling, on its income tax returns (R. 22):

Calendar Year	Period of Ownership	Depreciation Claimed
1955	10 days	\$ 3,786.50
1956	366 days	138,585.77
1957	357½ days	135,367.24
	Total	\$277,739.51

Petitioner's income tax returns for each of the years 1955 to 1957 were audited by the Internal Revenue Service. (R. 22.) The deductions claimed by petitioner for depreciation of the *Feuer* on the 1955 and 1956 returns were accepted by the Service without adjustment. (R. 5.) The depreciated cost of the *Feuer* as of the beginning of 1957 was \$326,627.73. (R. 5.)

On its 1957 income tax return, petitioner reported gross income (after direct cost of operations) of \$391,811.31, of which about \$289,340 represented gross profit from the operation of the *Feuer*. (R. 7.) After deductions of \$250,617.96, including \$135,367.24 for depreciation of the *Feuer*, petitioner reported taxable income of \$141,193.35. (R. 7.) The reported taxable income did not include the gain from the sale of the *Feuer*, which was nontaxable under section 337 of the Internal Revenue Code, but petitioner disclosed that gain on an information schedule. (R. 7.)

On audit of the 1957 return, respondent did not change the ruling of December 8, 1955, relating to useful economic life and salvage value of the *Feuer* (R. 5), and did not question the original estimate of a three-year useful

economic life for the *Feuer* in petitioner's business. (R. 14.) Nevertheless, respondent wholly disallowed the deduction for depreciation of the *Feuer* on the ground that petitioner "was not entitled to depreciation * * * under the applicable provisions of the Internal Revenue Code of 1954." (R. 7.)

The Tax Court sustained the disallowance of the 1957 depreciation deduction for the *Feuer*. (R. 18.) The Court of Appeals for the Second Circuit, Judge Moore dissenting (R. 82-90), affirmed the decision of the Tax Court. (R. 7[illegible].)

Summary of Argument

For over 40 years prior to the trial of this case, administrative, judicial, legislative and accounting authorities consistently and unanimously held that depreciation is allowable on property up to the date of sale, whether or not the sale is at a profit. Shortly before the trial of this case in 1962, the Commissioner of Internal Revenue decided to reject this long settled rule. Almost alone among the ten courts that have considered the Commissioner's new position, the Second Circuit in the decision below sustained it.

The disallowance of depreciation in the year of profitable sale violates the depreciation accounting practice that this Court has long held to be applicable for income tax purposes. Under that accounting practice the useful life and salvage value of the property are estimated at the time of its acquisition, and cost less salvage value is written off by a consistent method over the useful life. Salvage value under this practice may not be changed because of subsequent increases in price levels, whether or not realized by sale. To obtain a fair reflection of net income from operations, depreciation must be subtracted from gross operating income for the year of sale—whether the sale be at a profit or loss—and the profit or loss on the sale must be reflected in a nonoperating account. Any other rule would

distort both operating income and gain or loss on the sale. (Pp. 12-18, *infra.*)

From the enactment of the modern income tax until shortly before he announced his present view in 1962, the Commissioner regularly allowed depreciation in the year of profitable sale. His practice is shown in numerous decisions of this Court and lower courts extending from 1921 through 1960, in all of which the Commissioner had allowed depreciation straight through to the date of sale. A series of early rulings reflect the same practice. In the few cases where taxpayers questioned the Commissioner's practice, the courts squarely held that depreciation should be allowed for the year of sale, regardless of whether the sale produced a profit or a loss. In the one case in which the Commissioner put the question in issue by disallowing depreciation for the year of profitable sale, the Tax Court held in 1947 that the depreciation was allowable and the Commissioner, by promptly acquiescing in the decision, showed that he agreed. The accounting principle that year-of-sale depreciation was allowable thus became generally accepted, and was embodied in the Treasury's income tax regulations. (Pp. 18-29, *infra.*)

Congress repeatedly reenacted the statutory depreciation provision without relevant change, with knowledge that depreciation was deductible for the year of profitable sale. Congress even gave an example of such a deduction in its committee reports on the Revenue Act of 1950. In view of the close supervision of the statute by Congress and its knowledge of the precedents establishing that year-of-sale depreciation was allowable, its repeated reenactment of the statute must be deemed to have given those precedents the effect of law. (Pp. 29-41, *infra.*)

The Commissioner grounds his sudden abandonment of this long and well settled rule on the Sixth Circuit's 1958

decision in *Cohn* v. *United States, infra,* which the Commissioner contends held that depreciation for the year of profitable sale must be disallowed as a matter of law. To read the *Cohn* decision as the Commissioner has read it would make that decision violate every depreciation precedent. By 1958 the deductibility of year-of-sale depreciation had become too well established to be overturned by judicial fiat. (Pp. 46-48, *infra.*)

Furthermore, the briefs and opinion in the *Cohn* case show conclusively that the Sixth Circuit was not asked to hold, and did not hold, that depreciation for the year of profitable sale is barred as a matter of law. The Government argued on brief in the *Cohn* case that the district court had not based its determination of salvage value on sales price alone, but had made a factual determination on the basis of all the circumstances. Accepting this argument, the Sixth Circuit sustained the district court's finding of fact with respect to salvage value as not clearly erroneous. This narrow factual affirmance did not establish the broad rule of law the Commissioner is urging here. (Pp. 41-45, *infra.*)

The *Cohn* case is inapplicable here for the further reason that the sale of property in that case was made at or near the end of its useful life. In the present case the taxpayer sold the *Feuer* in the middle of its predictable useful life on receiving an unexpected offer of an attractive price from a competitor during the Suez Canal crisis. Since salvage value is the value of property at the end of its useful life, the price received on an unanticipated sale of property in the middle of its useful life does not establish its salvage value. (Pp. 45, 50, 52, *infra.*)

The Commissioner's recent decision to ignore both logic and history has been disapproved by the Eighth Circuit, the Tax Court and six of the seven District Courts that have considered it. The Tax Court, after temporarily embracing

the Commissioner's novel doctrine in an inadequately briefed case and then following it in the present case, recently repudiated it in a well-reasoned decision reviewed by the entire court. (Pp. 48-53, *infra.*)

The Commissioner's doctrine that any profitable sale of depreciable property bars depreciation for the year of sale—regardless of the reasonableness of the estimates of useful life and salvage value, the time during useful life at which the sale occurs, and the circumstances under which the sale occurs—should, therefore, be disapproved.

The decision below should be reversed without remand for further findings. The Tax Court's findings clearly establish that the taxpayer has proved the reasonableness of the depreciation deduction claimed by it. The deduction was computed under a useful life and salvage value established by a ruling obtained from the Commissioner when the ship was purchased in December of 1955. The Commissioner has never questioned the correctness of this determination of useful life and salvage value, and their correctness has been confirmed by extensive evidence presented to the Tax Court. The taxpayer has established that it is entitled to the reasonable allowance for depreciation claimed by it. (Pp. 53-55, *infra.*)

ARGUMENT

This case arises from an attempt of the Commissioner of Internal Revenue to reverse the interpretation long given to the income tax provision, now section 167(a) of the Internal Revenue Code, authorizing "as a depreciation deduction a reasonable allowance for the exhaustion, wear and tear (including a reasonable allowance for obsolescence) . . . of property used in the trade or business."

The parties agree that the components of the depreciation formula are the cost, salvage value and useful life of the property; that the accepted formula calls for cost less estimated salvage value to be written off by some consistent method over the estimated useful life; and that the property may not be depreciated below such salvage value. The dispute is over the deductibility of depreciation for the year of sale of the depreciable property at a profit. The petitioner-taxpayer contends that it is entitled to deduct depreciation up to the date of sale under the above formula and reasonable estimates of useful life and salvage value. The Commissioner of Internal Revenue disagrees. This disagreement is significant because depreciation deductions are subtracted from income taxable at ordinary rates; and, although the depreciation taken also reduces the basis of the property and thus increases the gain on its sale, that gain is usually taxed at the lower capital gains rate or, if a nonrecognition provision applies, is not taxed.[1]

I. Depreciation of Property for the Year of Its Profitable Sale Is Necessary To Reflect Income Clearly and Is Required by Sound Business Accounting Principles Approved by this Court for Income Tax Purposes.

Allowance for the exhaustion, wear and tear and obsolescence of business property for the year of its profitable sale is essential to a correct reflection of income from operations and to a correct reflection of gain or loss on the sale. This is one of the established rules of business depreciation accounting, the principles of which this Court has long recognized to govern tax depreciation.

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[1]Petitioner's gain on sale of the *Feuer* was not recognized by reason of the application of section 337 of the Internal Revenue Code. (R. 7, 78.)

The income tax statute authorizes deduction of depreciation as "charged in practical bookkeeping." *Stratton's Independence, Ltd.* v. *Howbert,* 231 U. S. 399, 423 (1913); *Von Baumbach* v. *Sargent Land Co.,* 242 U. S. 503, 524 (1917).[2] In response to the question "What was here meant by 'depreciation of property'?", this Court stated in the latter case: "We think Congress used the expression in its ordinary and usual sense as understood by business men." 242 U. S. at 524. In *United States* v. *Ludey,* 274 U. S. 295, 300-301 (1927), this Court applied for income tax purposes what Mr. Justice Brandeis, the author of the opinion, later called the "business men's practice" of depreciation.[3] The connotations of this income tax deduction, this Court more recently observed, are those of "accounting and engineering terminology." *Real Estate-Land Title & Trust Co.* v. *United States,* 309 U. S. 13, 16 (1940).

Depreciation accounting for business purposes is a process of cost allocation.[4] It aims to distribute the cost of business property, less its salvage value (if any), over its useful life in the business.[5] This accounting formula for depreciation was adopted by this Court for income tax purposes in *United States* v. *Ludey, supra.* The measure of the annual deduction, said Mr. Justice Brandeis for the Court, "is the sum which should be set aside for the taxable year, in order that, at the end of the useful life of the plant in the business, the aggregate of the sums set aside will (with

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[2]These cases arose under the depreciation provision of the Corporation Excise Tax Act of 1909, which was the direct predecessor of the depreciation provision for corporate taxpayers in the Revenue Act of 1913. Both such provisions are reproduced in Appendix B, *infra* pp. 1b-3b.

[3]Dissenting opinion in *United Railways and Electric Co.* v. *West,* 280 U. S. 234, 274 (1930).

[4]American Inst. of Accountants, Committee on Terminology, Accounting Terminology Bulletin No. 1, § 56 (1953).

[5]*Ibid*; Saliers, Depreciation Principles and Applications 159 (3d Ed. 1939).

the salvage value) suffice to provide an amount equal to the original cost." 274 U. S. at 300-301.

Cost is a known factor in the computation of depreciation, but useful life and salvage value must usually be estimated.[6] Inadequate or excessive depreciation resulting from erroneous estimates may be checked by periodic revision.[7] The estimate of useful life, and thus the depreciation rate, is subject to prospective correction on clear evidence;[8] and, since salvage value is the expected value at the end of useful life, revision of useful life may also require revision of salvage value.

Salvage value may not, however, be changed because of changes in price levels or market values. The fact that the property has appreciated in value furnishes no reason to adjust depreciation.[9] Revision of salvage value to reflect changing price levels "violates the basic concept of depreciation accounting because it does not fairly allocate the cost of depreciable property to income over its useful life."[10]

The rule that salvage value may not be changed to reflect changes in price levels applies not only to unrealized increase or decrease in value, but also to changes in price level realized by sale or other disposition of the property. The profit or loss upon retirement of the property is reflected in a "special profit or special loss account" rather than in the depreciation account, so that it "can be excluded

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[6]Saliers, *op. cit. supra* 130; Montgomery, Auditing 271 (8th Ed. 1957).

[7]Braunstein and Johnson, *Public Utility Depreciation and the Income Tax*, 52 Harv. L. Rev. 1077, 1087 (1939).

[8]Montgomery, *op. cit. supra* 271; Paton, Accountants' Handbook 729, 771 (3d Ed. 1943).

[9]Saliers, *op. cit. supra* 46, 135, 172-173; Montgomery, *op. cit. supra* 269; Paton, *op. cit. supra* 717, 718.

[10]Montgomery, *op. cit. supra* 273; Saliers, *op. cit. supra* 61, 68-69; 1 Dewing, The Financial Policy of Corporations 537, note f (5th Ed. 1953).

from the current expense and revenue data."[11] A loss from casualty, being in the nature of a capital loss, is likewise written off against surplus instead of being added to depreciation.[12] A sale is treated for this purpose exactly like any other retirement: "[t]he amount in the depreciation allowance applicable to the particular unit retired should be charged off, and the balance should be treated as a special profit . . . item."[13] If, for example, a retirement is made on September 15, depreciation for eight and one-half months is calculated.[14]

The function of depreciation in separating consumption through use from gain or loss on sale was well summarized by Mr. Justice Brandeis for this Court in the *Ludey* case. The annual depreciation allowance "represents the reduction, during the year, of the capital assets through wear and tear of the plant used." 274 U. S. at 300. He added that "by using up the plant, a gradual sale is made of it. The depreciation charged is the measure of the cost of the part which has been sold. When the plant is disposed of after years of use, the thing then sold is not the whole thing originally acquired. The amount of the depreciation must be deducted from the original cost of the whole in order to determine the cost of that disposed of in the final sale of properties." 274 U. S. at 301.

The purchaser of a ship or other depreciable business property having a salvage value pays, in effect, for two assets: the asset he expects to consume in his business (the "wasting asset") and the asset that will remain when the usefulness of the property to him ends (the "nonwasting

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[11]Paton, *op. cit. supra* 777. The only exception, Paton adds, is where the profit or loss is due, not to market factors, but to "understatement or overstatement of depreciation throughout the elapsed life."

[12]Saliers, *op. cit. supra* 132-133.

[13]Paton, *op. cit. supra* 685.

[14]*Id.* at 773.

asset"). Salvage value is the portion of the total cost allocated to the nonwasting asset. The allocation resembles that made by the purchaser of improved real estate between the building (wasting asset) and the land (nonwasting asset). This allocation of cost is necessary because the cost of the wasting asset is distributed over its useful life and the cost of the nonwasting asset is reserved for determination of gain or loss on its disposition. If the value of the nonwasting asset increases above its cost in a rising market, this does not show that the cost allocation was wrong. If the increased value of the nonwasting asset in the rising market is realized by sale, this does not prove that the writeoff of the cost of the wasting asset has been excessive.

Only by adhering to a cost allocation fairly made on the basis of the conditions existing at the time of purchase can the allowance for consumption of the wasting asset be properly separated from the gain or loss on disposition of the nonwasting asset. The former occurs through use and passage of time; the latter is the result of inflation, scarcity and other market factors. Adherence to that cost allocation produces a fair reflection of income from operations by separating operating revenue and expense from special profit or loss upon sale of plant or equipment.

The Second Circuit has erroneously substituted for this sound principle of depreciation accounting a new theory recently improvised by the Commissioner. Under this new theory, depreciation for the year of sale of property is calculated by substituting the selling price of the property for the portion of the cost assigned to the nonwasting asset. "All that is required" to compute depreciation for the year of sale, says the Second Circuit, "is a comparison of the

asset's selling price with its adjusted basis." (R. 81.) Coining the phrase "net cost" to describe the difference between cost and selling price, the Second Circuit asserts that "the depreciation allowance is measured by the net cost of the asset to the taxpayer." (R. 81.) This novel rule is to be blindly applied even though "the depreciation schedule adopted by the taxpayer" is not "unreasonable" (R. 80) and "the increment in . . . value" realized on sale "resulted from a fortuity normally associated with capital gain." (R. 81.)

The Second Circuit aggravates its error by applying its "net cost" rule to the computation of depreciation for the year of unanticipated sale of property in the middle of its useful life.[15] In such a sale, the purchaser pays for going-concern value or increased profitability from use of the property. The realization of such potential excess of earning capacity has nothing to do with depreciation.[16] The Second Circuit, in computing depreciation for the year of sale by substituting a known quantity (sales price in the middle of useful life) for an estimate (salvage value at the end of useful life), forgot that the known figure was not relevant to the computation under depreciation accounting principles.

The Second Circuit's error is most simply illustrated in terms of the type of depreciable property, such as a patent, that inherently has no salvage value. Assume that a taxpayer purchases for $100,000 a patent that will expire in five years, and that the patent yields him royalties of $30,000 annually. On the straight-line basis the taxpayer writes off $20,000 of the cost of the patent against each year's royalties. His decision at the end of the third year

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[15]See p. 4, *supra*, as to the circumstances of petitioner's sale of the *Feuer*.

[16]Dewing, *op. cit. supra* note 11, at 581 note mmm.

to realize through sale the expected earnings of the patent for the remaining two years[17] should not deprive him of depreciation for the year of sale. The allocation of the cost of the patent 60 percent to the sales price and only 40 percent to the three years of its productivity for the taxpayer is an abuse of depreciation principles for ulterior ends.

The Second Circuit's departure from the theory and practice of depreciation accounting unfairly commingles and distorts two separate taxable events—the income from use of property and the gain on its sale—for which Congress has provided different methods of taxation.

II. Deductibility of Depreciation for the Year of Sale Is Established by Administrative, Judicial and Legislative Precedent and Has Become a Rule of Law by Reenactment of the Statute.

Allowance of depreciation for the year of sale of property—whether or not the sale is at a profit—is established by more than four decades of administrative practice and rulings, by judicial decisions, and by clearly announced Congressional views, and has been elevated to a rule of law by repeated statutory reenactment.

A. Long Standing Administrative and Judicial Precedent Establishes that Depreciation Is Deductible for the Year of Sale.

From the enactment of the modern income tax until very recently, all parties concerned—the Commissioner, taxpayers and the courts (including this Court)—accepted for tax purposes the accounting principle that depreciation

[17] "The value of a patent lies primarily in the probable earnings it will bring its owner." Paul, Federal Estate and Gift Taxation, 1249 (1942).

should be taken in the year of profitable sale of depreciable property. A long series of court decisions reflects the Commissioner's practice of allowing such depreciation and the acceptance of that practice by taxpayers generally and by the courts. Since most of the affected taxpayers, though disputing other adjustments, accepted the principle that depreciation is allowable for the year of the profitable sale, that principle was usually not placed in issue. Nevertheless, this long line of cases clearly shows that the Commissioner, the taxpayers and the courts regularly took for granted that the sale of property at a profit does not prevent deduction of depreciation for the year of sale.

An early example of the allowance of depreciation for the year of profitable sale is *Eldorado Coal & Mining Co.* v. *Mager*, 255 U. S. 522 (1921), where the issue was whether gain on sale of a mining plant is constitutionally taxable as income. Both the taxpayer and the Commissioner computed gain on the sale in that case by subtracting depreciation "to the date of sale." 255 U. S. at 526.[18] This practice was again reflected in *United States* v. *Ludey*, *supra*, in which this Court held that the basis of property had to be reduced by depreciation for the purpose of determining gain on its sale.[19] The Commissioner, in determining the basis of property sold in February 1917, reduced original basis by depletion and depreciation sustained up to "the date of sale in February 1917," and the Court of Claims employed this method of computation in making its findings as to the amount of depreciation sustained. *Ludey* v. *United States*, 61 Ct. Cl. 126 (1925), and Finding V therein. In its brief in the *Ludey* case in this Court, the Government specifically acknowledged that the taxpayer

[18]See also Transcript of Record, *Eldorado Coal & Mining Co.* v. *Mager*, at pp. 3-4.

[19]There was no such specific statutory requirement prior to enactment of the Revenue Act of 1924, discussed at p. 33, *infra*.

was entitled to deduct for 1917, the year of sale, the depreciation actually sustained for that year.[20] Unlike depreciation, the full amount of depletion sustained was not necessarily deductible under the Revenue Act of 1913, and this Court therefore remanded the case so that the reduction of basis could be limited to the amount of deductions found to be allowable. However, this Court did not question the principle that the period for computing depreciation or depletion extended up to the date of sale.

The Commissioner's practice of allowing depreciation to the date of sale was also accepted without question in cases involving various contested issues by the Second Circuit in *Kittredge* v. *Commissioner,* 88 F. 2d 623 (2d Cir. 1937) and *Beckridge Corp.* v. *United States,* 129 F. 2d 318 (2d Cir. 1942); by the Third Circuit in *Clark Thread Co.* v. *Commissioner,* 100 F. 2d 257 (3d Cir. 1938), aff'g 28 B. T. A. 1128, 1140, 1150-51 (1933); by the Eighth Circuit in *Forrester Box Co.* v. *Commissioner,* 123 F. 2d 225 (8th Cir. 1941); by the Court of Claims in *Hall* v. *United States,* 43 F. Supp. 130 (Ct. Cl.), *cert. denied,* 316 U. S. 664 (1942); and repeatedly by the Board of Tax Appeals and the Tax Court. *Grosvenor Atterbury,* 1 B. T. A. 169 (1924); *Even Realty Co.,* 1 B. T. A. 355 (1925); *W. W. Carter Co.,* 1 B. T. A. 849 (1925); *Keighley Mfg. Co.,* 2 B. T. A. 10 (1925); *Marchetti Roma Cafe Co.,* 2 B. T. A. 529 (1925); *Walter Frank,* 2 B. T. A. 905 (1925); *Cotton Concentration Co.,* 4 B. T. A. 121 (1926); *Capital City Investment Co.,* 4 B. T. A. 933 (1926); *Island Line Shipping Co.,* 4 B. T. A. 1055 (1926); *Seton Falls Realty Co.,* 6 B. T. A. 883 (1927); *Parkersburg & Marietta Sand Co.,* 11 B. T. A. 87 (1928); *Louis Kalb,* 15 B. T. A. 865 (1929); *Max Eichenberg,* 16 B. T. A. 1368 (1929); *Franklin Lumber & Power Co.,* 18 B. T. A. 1207 (1930), *rev'd on other*

[20]Brief for the United States, *United States* v. *Ludey,* p. 7.

grounds, 50 F. 2d 1059 (4th Cir. 1931); *Bolta Co.,* T. C. Memo. 5638, 4 CCH T. C. Memo. 1067 (1945).

The deductibility of depreciation for the year of profitable sale was also recognized in a series of early rulings dealing with adjustment of basis for depreciation. In 1922 the Commissioner ruled that depreciation should be computed to the date of disposition of property (I. T. 1158, I-1 C. B. 173); in the same year he described in a ruling the depreciation of an asset to $40,000 in the year of its sale for $47,000 (I. T. 1494, I-2 C. B. 19); in 1924 he again stated that property should be depreciated straight up to the date of its profitable sale (A. R. R. 6930, III-1 C. B. 45); and in 1927 the Commissioner approved a computation of gain on sale of an asset for which depreciation was deducted for the year of sale (G. C. M. 1597, VI-1 C. B. 71).

The Commissioner, having initiated the practice of allowing depreciation for the year of profitable sale under the early Revenue Acts, continued it throughout the succeeding decades, as reflected in recent cases in this Court. In calculating the tax deficiencies of one of the two taxpayers involved in *Massey Motors, Inc.* v. *United States,* 364 U. S. 92 (1960), the Commissioner used a salvage value of $1325 for automobiles sold in the same year for an average of $1380.[21] 364 U. S. at 94-95. Similarly, in the companion case of *Hertz Corporation* v. *United States,* 364 U. S. 122 (1960), the Commissioner accepted returns claiming depreciation under a formula involving deduction of depreciation straight through to the date of profitable sale, and objected only to the taxpayer's attempt to obtain

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[21]No. 143, *Commissioner* v. *Evans.* Since the Commissioner had taken the position in No. 141, *Massey Motors, Inc.* v. *United States,* that the assets were not depreciable because held for sale to customers, that case did not show his depreciation practice.

refunds by changing retroactively to a 200% declining balance method.[22]

Although the general acceptance of the view that depreciation was deductible for the year of profitable sale limited litigation of the issue, the deduction was expressly sustained whenever the issue arose. In *Duncan-Homer Realty Co.,* 6 B. T. A. 730 (1927), the taxpayer, having made a profitable sale during 1923 of real property it had purchased in 1922, deducted depreciation on the property for both years but did not reduce basis by the amount of such depreciation in computing gain on the sale. The gain was taxable as ordinary income because the property had not been held for the two-year period then necessary for capital gain treatment.[23] The Commissioner, while reducing the basis of the property by the amount of the 1922 depreciation for the purpose of determining gain on the sale, disallowed the 1923 depreciation deduction and did not reduce basis for it. In considering the taxpayer's contention that the 1923 depreciation was allowable, the Board of Tax Appeals approved the Commissioner's disallowance only because, the gain on the sale being ordinary income, the resulting tax was the same as if the Commissioner had allowed the 1923 depreciation deduction and reduced basis for it. The Board ruled that the Commissioner's action "was not because of any question as to the right of the petitioner to make the deduction, nor as to the reasonableness of the amount thereof, but rather, it appears, to shorten the computation." 6 B. T. A. at 732.

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[22]See *Hertz Corporation* v. *United States,* 165 F. Supp. 261, 265, 269 (D. Del. 1958), *rev'd,* 268 F. 2d 604 (3d Cir. 1959), *aff'd,* 364 U. S. 122 (1960). The existence of gain on sales of some of the automobiles was clearly shown on exhibits attached to the returns as filed. See pp. 13-18 of the Transcript of Record for that case in this Court.

[23]Rev. Act of 1921, § 206(a)(6), quoted on p. 32, *infra.*

The Board of Tax Appeals later held in *Herbert Simons,* 19 B. T. A. 711 (1930), that a taxpayer had to depreciate property for the year of its profitable sale, even though the depreciation deduction was wasted because his other deductions exceeded his ordinary income for that year. The taxpayer had, during 1924, realized a large capital gain upon sale of an apartment house he had purchased three years earlier. He sought to reduce his capital gain by foregoing depreciation of the apartment house for that year, both as a deduction and as a basis adjustment. The Commissioner contended that the 1924 depreciation deduction "was legal and proper," and the Board upheld this contention as "in accord with the purpose and policy of our revenue statutes, as the same have been interpreted and construed by the courts and this Board." 19 B. T. A. at 712-713.

The issue now before this Court was again squarely resolved by allowance of depreciation for the year of profitable sale in *Wier Long Leaf Lumber Co.,* 9 T. C. 990 (1947), *aff'd and rev'd on other issues,* 173 F. 2d 549 (5th Cir. 1949). A lumber company, having sold some of its business automobiles during 1942, deducted depreciation for that year in amounts that brought the depreciated cost of the automobiles below the price received for them. The parties stipulated in the Tax Court that the depreciation was proper and should be allowed unless it was "controlled by the price received for the automobiles upon the sale thereof." 9 T. C. at 992. The question of law before the Tax Court under this stipulation was "whether the price received from the sale of the depreciated automobiles precludes any depreciation allowance" for the year of sale. 9 T. C. at 999.

Answering this question in the negative, the Tax Court held that depreciation "can not be disallowed merely by

reason of the price received for the article without consideration of other factors." If the profitable price received for the automobiles was due to "a miscalculation as to their useful life" depreciation might be adjusted. But "mere appreciation in value due to extraneous causes has no influence on the depreciation allowance, one way or the other." The "sole fact . . . that a given price is received for articles not fully depreciated throws no light . . . upon the depreciation allowance." 9 T. C. at 999.

The Tax Court did not hold in *Wier* that the Commissioner must accept erroneous estimates of salvage value. Bad estimates are always subject to challenge, even for the year of sale. This is shown by the Tax Court's holding in the same case with respect to the issue of depreciation of a sawmill. The lumber company had depreciated the mill, which it had acquired with an extensive tract of standing timber in 1918, under a formula involving an assumed salvage value of $15,000. On January 1, 1942, the mill had a depreciated cost of less than $25,000, and the company had remaining less than a year's supply of standing timber. In December of 1942, after cutting almost all of the timber, the company sold the mill and certain equipment for $75,000. The company deducted almost $10,000 of depreciation with respect to the mill for 1942, which the Commissioner disallowed. 9 T. C. at 991-992. The company presented no evidence in the Tax Court of the "amount which should properly be attributed to anticipated salvage of the mill." 9 T. C. at 999. Since the company had failed to meet its burden of showing that the mill had not been fully depreciated at the beginning of 1942, the Tax Court sustained the Commissioner's disallowance.

The Tax Court's decision with respect to the mill thus supports and clarifies its decision with respect to the automobiles. The sale of property for more than its depreciated

cost at the beginning of the year of sale does not require disallowance of depreciation for that year as a matter of law. What is reasonable depreciation remains a question of fact to be determined from all known conditions. 9 T. C. at 998.

The Commissioner promptly acquiesced in the *Wier* decision.[24] Since the automobile depreciation issue was the only one decided adversely to the Commissioner by the Tax Court in the *Wier* case, the meaning of the acquiescence is clear. Having been rebuffed in his only attempt, in disregard of the existing rulings and cases, to establish a rule of law denying depreciation of property for the year of its profitable sale, the Commissioner publicly agreed that there was no such rule of law.

The income tax regulations relating to depreciation furnish further proof of the Commissioner's continuing acceptance of the allowability of year-of-sale depreciation. Preparation of the depreciation regulations under the Internal Revenue Code of 1954 received extensive consideration.[25] Those regulations are far more detailed than the depreciation provisions of earlier editions of the income tax regulations.[26] They specify that an asset may not be depreciated below a reasonable salvage value;[27] that salvage value shall not be changed merely because of changes in price levels and shall be redetermined only when useful life is also redetermined;[28] that a proportionate part of one

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[24]1948-1 C. B. 3. See note 75, *infra* p. 40, as to the recent withdrawal of this acquiescence.

[25]The depreciation regulations first proposed under the 1954 Code, which were issued under a notice of proposed rule making on September 28, 1954, were withdrawn in favor of a new set of proposed regulations on November 9, 1955. 20 F. R. 8454. After further revision following public comment and hearings, the regulations were finally approved on June 7, 1956 by T. D. 6182, 1956-1 C. B. 98.

[26]Compare Treas. Reg. §§ 1.167(a)-1 to 1.167(i)-1 with Treas. Reg. 118, §§ 39.23(l)-1 to 39.23(l)-10.

[27]Treas. Reg. § 1.167(a)-1(a).

[28]Treas. Reg. § 1.167(a)-1(c).

year's depreciation is allowable for that part of the last year during which the asset was in service;[29] that when an asset is retired or disposed of, appropriate adjustments shall be made in the asset and depreciation reserve accounts;[30] that when an asset is sold at arm's length, recognition of gain or loss is subject to the provisions of sections 1002, 1231 and other provisions of law;[31] and that upon sale or other retirement of an asset from a multiple asset account the "salvage value estimated in determining the depreciation deduction" shall be used as the "adjusted basis" of the asset "for determining gain or loss upon . . . sale."[32] It is inconceivable that the regulations could have been so written if they had not been intended to conform to the Commissioner's acquiescence in the *Wier* case. It is equally inconceivable that the Commissioner would have decided by 1956 to do an about-face on this issue without clearly so stating in these otherwise detailed regulations.

If further proof were needed, it is found in the Commissioner's republication in the regulations in 1957[33] of a computation, originally introduced into the regulations in 1951,[34] showing depreciation to be deductible for the year of profitable sale. These regulations, interpreting the statutory requirement that gain upon the sale of amortiza-

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[29]Treas. Reg. § 1.167(a)-10(b).

[30]Treas. Reg. § 1.167(a)-1(c).

[31]Treas. Reg. § 1.167(a)-8(a)(1).

[32]Treas. Reg. § 1.167(a)-8(c). The term "retirement" as used in this regulation includes sale, Treas. Reg. § 1.167(a)-8(a).

[33]Treas. Reg. § 1.1238-1, Example (1), adopted by T. D. 6253, 1957-2 C. B. 547, 562, as it read prior to its amendment on June 2, 1965 by T. D. 6825, 1965-26 I. R. B. 6. See text at note 76, *infra* p. 40, as to such recent amendment.

[34]Treas. Reg. 111, §29.117-9(a), added by T. D. 5851, 1951-2 C. B. 63. This regulations provision was based on the Report of the House Committee on Ways and Means discussed at pp. 34-35, *infra*. The provision was also republished in 1953 in Treas. Reg. 118, § 39.117(g)-2(a).

ble emergency facilities be treated as ordinary income to the extent of the excess of amortization over depreciation, provide a computation of gain on sale of the unamortizable portion of the facility. In the example, the unamortizable portion of a facility having a useful life of 20 years was purchased on December 31, 1954, for $10,000; depreciation of $500 a year was deducted for each of the years 1955 and 1956, bringing the depreciated cost to $9,000; and, upon sale of the unamortizable portion of the facility on December 31, 1956, for $9,500, a $500 capital gain was realized. Sale of the property at the end of 1956 for an amount equal to its depreciated cost at the beginning of that year does not bar deduction of a full year's depreciation.

The rule that the actual period of use and sales price do not supplant proper estimates of useful life and salvage value is established not only by the above precedents dealing with a profitable sale, but also by rulings and decisions where the sale was at a loss. Thus, the Commissioner ruled in O. D. 753, 3 C. B. 171 (1920), that the sale of depreciable property at a loss did not terminate its useful life and did not permit an increased depreciation deduction for the year of sale. Similarly, in *Star Sporting Goods Co.*, 1 B. T. A. 1266 (1925), the Commissioner, with the approval of the Board of Tax Appeals, limited depreciation for the year of unprofitable sale to the amount computed under the original estimates of useful life and salvage value, and reduced basis for such depreciation in computing loss on the sale. And in *Thomas Goggan & Bro.*, 45 B. T. A. 218 (1941), the Board squarely held that the amount realized on disposition of property at a loss does not automatically become salvage value.

The taxpayer in the *Goggan* case traded in a business automobile during 1938 at a trade-in allowance about $200 less than depreciated cost. Since deduction of the $200 loss

was prevented by a nonrecognition provision,[35] the taxpayer sought to augment by that amount its depreciation deduction for the year of trade. However, the Board of Tax Appeals, sustaining the Commissioner, limited depreciation to the rate used in prior years. The "allowance of depreciation," said the Board, "depends upon the actual usage of the property." The "trade-in value allowed on an automobile which has been used in a trade or business for a given period can not be said to determine the amount or the rate of the depreciation to be allowed on it in any year of its use." 45 B. T. A. at 225.

The Fifth Circuit espoused the same view in *Whitaker v. Commissioner,* 259 F. 2d 379 (5th Cir. 1958), in which the taxpayer had purchased a race horse in August 1948 for $9,000 and, after the horse became injured, sold it in December 1950 for $1,000. The Commissioner allowed depreciation on the horse at the rate of $1,500 a year for the 2⅓ years of ownership, bringing the depreciated cost in December 1950 to $5,500, and treated the difference between such depreciated cost and the $1,000 sale price as a long-term capital loss. The Fifth Circuit, affirming the Tax Court, rejected the taxpayer's argument that the sale of the race horse established its salvage value. The Fifth Circuit, comparing a race horse to a delicate piece of machinery, said that "on a straight line basis, an allowance for accelerated depreciation depends upon showing that the effective life of the machinery was shortened by excessive use, added wear and tear." 259 F. 2d at 385. Realization of a change in value through sale will not sustain a change in depreciation unless it is related to the factor of wear and tear.

In summary, a wealth of precedent accumulated over the decades of the modern income tax establishes beyond

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[35]Rev. Act of 1938, § 112(b)(1).

doubt the correctness of the taxpayer's position here. Useful life and salvage value, if fairly established, are not automatically supplanted for depreciation purposes by the actual period of use and the amount realized on sale. For both business accounting and income tax purposes, depreciation in the year of profitable sale is necessary to a fair separation of operating income from gain on sale.

B. Deductibility of Year-of-Sale Depreciation Is Established as a Rule of Law by Legislative History and Reenactment.

Over the same decades in which the abundant judicial and administrative precedent we have discussed was accumulating, Congress repeatedly reenacted the depreciation provision without relevant change. The key words of the present statute—"a reasonable allowance for the exhaustion, wear and tear" of business property—were first enacted in the Revenue Act of 1913.[36] Congress reenacted these words in the Revenue Acts of 1916, 1918, 1921, 1924, 1926, 1928, 1932, 1934, 1936 and 1938 and in the Internal Revenue Codes of 1939 and 1954.[37]

This Court has held many times that Congressional reenactment of a statute without relevant change is deemed to give the force and effect of law to the prior long-continued and uniform judicial or administrative construction of the statute. *Cammarano* v. *United States,* 358 U. S. 498, 510-511 (1959); *United States* v. *Allen-Bradley Co.,* 352 U. S. 306, 310 (1957); *Corn Products Refining Co.* v. *Commissioner,* 350 U. S. 46, 52-53 (1955); *Lykes* v. *United States,* 343 U. S. 118, 127 (1952); *Wilmette Park Dist.* v. *Campbell,* 338 U. S. 411, 417-418 (1949); *Commissioner*

[36]Rev. Act of 1913, §IIB, reproduced in Appendix B, *infra* pp. 1b-3b.

[37]The depreciation provisions of these Acts and Codes are cited and reproduced in Appendix B, *infra* pp. 1b-3b.

v. *Flowers,* 326 U. S. 465, 469 (1946); *Boehm* v. *Commissioner,* 326 U. S. 287, 291-292 (1945); *White* v. *United States,* 305 U. S. 281, 291 (1938); *Helvering* v. *Winmill,* 305 U. S. 79, 83 (1938); *Taft* v. *Commissioner,* 304 U. S. 351, 356-357 (1938); *Hartley* v. *Commissioner,* 295 U. S. 216, 220 (1935); *Old Mission Portland Cement Co.* v. *Helvering,* 293 U. S. 289, 293-294 (1934); *Reinecke* v. *Smith,* 289 U. S. 172, 175 (1933); *United States* v. *Dakota-Montana Oil Co.,* 288 U. S. 459, 466 (1933); *Norwegian Nitrogen Products Co.* v. *United States,* 288 U. S. 294, 313-315 (1933); *Mass. Mutual Life Ins. Co.* v. *United States,* 288 U. S. 269, 273 (1933); *Costanzo* v. *Tillinghast,* 287 U. S. 341, 345 (1932); *Murphy Oil Co.* v. *Burnet,* 287 U. S. 299, 307 (1932); *United States* v. *Ryan,* 284 U. S. 167, 174-175 (1931); *McCaughn* v. *Hershey Chocolate Co.,* 283 U. S. 488, 492-493 (1931); *Brewster* v. *Gage,* 280 U. S. 327, 337 (1930); *National Lead Co.* v. *United States,* 252 U. S. 140, 146-147 (1920); *United States* v. *Cerecedo Hermanos y Compania,* 209 U. S. 337, 339 (1908); *United States* v. *Bailey,* 9 Pet. (U. S.) 238, 253 (1835). In *Helvering* v. *Winmill, supra,* Mr. Justice Black, speaking for the Court, said: "Treasury regulations and interpretations long continued without substantial change, applying to unamended or substantially reenacted statutes, are deemed to have received Congressional approval and have the effect of law." 305 U. S. at 83.

In the above cases this Court invoked the reenactment rule to validate interpretations on which the Government was continuing to rely. However, the rule applies with equal force to prevent Government officials from doing an about-face on long-continued interpretations that have earned Congressional approval through statutory reenactment. *United States* v. *Leslie Salt Co.,* 350 U. S. 383, 396-397 (1956); *McFeely* v. *Commissioner,* 296 U. S. 102,

109-110 (1935); *Zellerbach Paper Co.* v. *Helvering,* 293 U. S. 172, 179-180 (1934); *Helvering* v. *Bliss,* 293 U. S. 144, 151 (1934); *Poe* v. *Seaborn,* 282 U. S. 101, 116 (1930). As Mr. Justice Harlan said for this Court in *United States* v. *Leslie Salt Co., supra,* "Against the Treasury's prior longstanding and consistent administrative interpretation its more recent *ad hoc* contention as to how the statute should be construed cannot stand." 350 U. S. at 396.

This is not a case in which no reliable inference can be drawn from reenactment because of a lack of long and well settled interpretation or the presence of a conflict in administrative and judicial interpretation at the time of reenactment. Cf. *Commissioner* v. *Acker,* 361 U. S. 87, 93 (1959); *United States* v. *Calamaro,* 354 U. S. 351, 358-359 (1957); *Commissioner* v. *Glenshaw Glass Co.,* 348 U. S. 426, 431-432 (1955); *Jones* v. *Liberty Glass Co.,* 332 U. S. 524, 533-534 (1947); *White* v. *Winchester Country Club,* 315 U. S. 32, 39-40 (1942); *Helvering* v. *Reynolds,* 313 U. S. 428, 430, 433 (1941); *Higgins* v. *Smith,* 308 U. S. 473, 479 (1940); *Helvering* v. *Wilshire Oil Co.,* 308 U. S. 90, 99-100 (1939); *Helvering* v. *New York Trust Co.,* 292 U. S. 455, 467-468 (1934); *Iselin* v. *United States,* 270 U. S. 245, 251 (1926). Instead, the pattern here is of unambiguous administrative conduct "adopted by the Commissioner in the early days of federal income tax legislation, in continuous existence since that time, and consistently construed and applied by the courts on many occasions." *Cammarano* v. *United States, supra,* at 511.

Moreover, this is not a case in which the reenactment rule is inapplicable because the long-settled interpretation plainly misinterpreted an unambiguous statute. Cf. *Jones* v. *Liberty Glass Co., supra; Biddle* v. *Commissioner,* 302 U. S. 573, 582 (1938); *Louisville & Nashville R. R.* v. *United States,* 282 U. S. 740, 757-758 (1931); *Iselin* v.

United States, supra. The statute is not "so plain in its commands as to leave nothing for construction." *Norwegian Nitrogen Products Co.* v. *United States, supra,* at 315. Administrative construction followed by reenactment is given particular weight where the statute is sufficiently general or doubtful as to give broad interpretive discretion. *United States* v. *Allen-Bradley Co., supra,* at 308-309; *McCaughn* v. *Hershey Chocolate Co., supra,* at 492.

This Court has presumed without express proof that Congress in reenacting a statute is familiar with interpretations of it which are published and long-standing.[38] It is not necessary, however, to indulge in such a presumption here, for, as we show below, this case involves the "close supervision" of the statute by Congress that this Court found meaningful in *United States* v. *Allen-Bradley Co., supra,* at 310.

In 1921 Congress first enacted favorable tax treatment for capital gain. Such treatment was granted to sales of property, including depreciable property, "acquired and held by the taxpayer . . . for more than two years (whether or not connected with his trade or business)."[39] This Court has held that this first enactment of a reduced rate for capital gain should not be held to circumscribe deductions "granted in the earlier Acts, and retained in later ones, . . . unless that result be plainly required by the language used."[40] It is clear that Congress did not intend to circumscribe the depreciation deduction, for it reenacted it without

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[38]See cases cited at pp. 29-30, *supra.* This presumption is not applied to interpretations of short duration, *United States* v. *Calamaro, supra; Helvering* v. *New York Trust Co., supra,* or to an "administrative practice not reflected in any published ruling or regulation." *Commissioner* v. *P. G. Lake, Inc.,* 356 U. S. 260, 266 note 5 (1958).

[39]Rev. Act of 1921, § 206(a)(6).

[40]*Helvering* v. *Bliss, supra* p. 31, at 151.

change.[41] And it did so with obvious familiarity with current interpretations, for the accompanying committee report cited the two companion decisions of this Court to *Eldorado Coal & Mining Co.* v. *Mager, supra.*[42]

In 1924 Congress legislated against the taxpayer practice of not reducing the basis of depreciable property by depreciation for the purpose of determining gain or loss upon sale.[43] The accompanying committee report announced that this legislative provision "is substantially the same as the construction placed upon the existing law by the Treasury Department."[44] Since the construction to which Congress thus referred was set forth in the rulings and cases we have described allowing depreciation for the year of profitable sale, Congress demonstrably had knowledge that depreciation was deductible for that year.

In 1938 Congress excluded depreciable business property from the definition of a capital asset.[45] However, Congress took this action, not out of concern that taxpayers were realizing capital gain on sales of depreciable property, but so that loss on sales of such property would be fully deductible from ordinary income instead of subject to capital loss limitations.[46] The report of the Committee on Ways and Means on this provision made it clear that, but for the change, loss on sale of a depreciable asset could not be charged against ordinary income.[47] This report thus exhibited Congressional knowledge of the principle

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[41] Rev. Act of 1921, §§ 214(a)(8) and 234(a)(7), reproduced in Appendix B, *infra* pp. 1b-3b.

[42] S. Rep. No. 275, 67th Cong., 1st Sess. 15 (1921), citing *Goodrich* v. *Edwards*, 255 U. S. 527 (1921), and *Walsh* v. *Brewster*, 255 U. S. 536 (1921).

[43] Rev. Act of 1924, § 202(b). See pp. 19-21, *supra*.

[44] H. Rep. No. 179, 68th Cong., 1st Sess. 12 (1924).

[45] Rev. Act of 1938, § 117(a)(1).

[46] H. Rep. No. 1860, 75th Cong., 3d Sess. 6 (1938).

[47] *Id.* at 34-35.

of O. D. 753 and the *Star Sporting Goods* case, *supra* p. 27, that sales price does not supplant salvage value.

In 1942 Congress restored capital gain treatment to depreciable business property.[48] The accompanying committee report stated that "it appears that many taxpayers are able to dispose of their depreciable property at a gain over its depreciated cost. To treat such a gain as an ordinary gain will result in an undue hardship to the taxpayer."[49] At the same time, Congress left the depreciation provision unchanged except for expanding its scope to cover nonbusiness property held for the production of income.[50]

Thereafter and up to the time of the most recent reenactment of the depreciation provision in 1954, Congress was again concerned with the relationship between depreciation and capital gain on the following occasions:

(1) In 1947 Congress received from the Treasury Department, but did not adopt, a legislative recommendation that gains on sales of assets subject to accelerated depreciation should, to the extent of the excess of accelerated over normal depreciation, be treated as ordinary income.[51]

(2) In developing the Revenue Act of 1950, Congress considered but rejected a proposal that all gains from sales of depreciable property be taxed as ordinary income.[52] At

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[48]Int. Rev. Code of 1939, § 117(j), added by Rev. Act of 1942, § 151(b).

[49]H. Rep. No. 2333, 77th Cong., 2d Sess. 54 (1942).

[50]Rev. Act of 1942, § 121(c).

[51]Hearings before the Committee on Ways and Means, House of Representatives, 80th Cong., 1st Sess. on Revenue Revisions 1947-48, Part 5, page 3756 (Report of Business Tax Section, Division of Tax Research, Treasury Department). See note 63, *infra* p. 38.

[52]The 1950 Act as passed by the House of Representatives followed the recommendation of the Treasury Department that losses on sales of depreciable assets be treated as capital rather than ordinary losses. H. Rep. No. 2319, 81st Cong., 2d Sess. 45 (1950). The Senate rejected this change (S. Rep. No. 2375, 81st Cong., 2d

the same time, Congress enacted a provision requiring gain upon sale of amortizable emergency facilities to be treated as ordinary income to the extent of the excess of amortization over depreciation.[53] The conference report on this provision expressly recognized that depreciation was deductible up to the date of profitable sale of depreciable property. The report gave an example of the sale for $9,500 of an emergency facility having a basis after amortization of $6,000. Depreciation (including $500 for the year of sale) would have brought its basis down only to $9,000. The report stated that $3,000 of the gain on sale would be treated as ordinary income and $500 as capital gain.[54] The clearly expressed Congressional view was that realization of capital gain upon the sale of the depreciable asset does not bar depreciation for the year of sale.

(3) In 1951 the Internal Revenue Service called the attention of Congress to sales of depreciated assets between related taxpayers for the purpose of obtaining a combination of capital gain on the sale and an increased basis for future depreciation.[55] Congress legislated against this device by requiring gain on sales between an individual and his controlled corporation or between certain closely related individuals to be treated as ordinary income,[56] but left

Sess. 51-52 (1950)) and its approach prevailed. In the Senate floor discussion, Senator Millikin (the ranking minority member of the Committee on Finance) stated that "the reverse procedure which involves conforming the treatment of gains to losses and taxing the gains on the sale of section 117(j) assets as ordinary income also present serious difficulties" and, hence, the "Committee decided that it was best not to change section 117(j) at this time." 96 Cong. Rec. 14057 (1950).

[53]Rev. Act of 1950, § 216(c).

[54]H. Rep. No. 3124, 81st Cong., 2d Sess. 29 (1950). This Report was the basis of the similar example in the Treasury Regulations referred to at pp. 26-27, *supra*.

[55]H. Rep. No. 586, 82d Cong., 1st Sess. 26 (1951).

[56]Int. Rev. Code of 1939, § 117(o), added by Rev. Act of 1951, § 328(a).

capital gain treatment otherwise available for sales of depreciable assets.

(4) During the development of the Internal Revenue Code of 1954, Congress again received, but did not adopt, a recommendation that gains from sales of depreciable assets should be taxed as ordinary income.[57] Congress reenacted capital gain treatment for depreciable assets in 1954[58] even though it realized that the new rapid depreciation methods it was authorizing would accentuate the advantage of capital gain treatment.[59] The report of the Committee on Finance on the new depreciation provisions showed Congressional awareness that estimated salvage value may not be adjusted downward to coincide with the price received on sale of depreciable property at a loss.[60]

Congressional understanding of the interrelation between depreciation and gain on sale, and its knowledge that depreciation is allowable for the year of sale, is manifest in the above legislative history. This history of informed Congressional reenactment and legislative revision calls for application of the doctrine that the reenacted statute embodies the long and uniform interpretation. That doctrine

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[57]Hearings before the Committee on Finance, United States Senate, 83d Cong., 2d Sess. on H. R. 8300, Part 3, p. 1324 (Recommendation No. 180 of American Inst. of Accountants).

[58]Int. Rev. Code of 1954, § 1231. "This section is derived from section 117(j) of present law. There is no substantive change intended. . . ." H. Rep. No. 1337, 83d Cong., 2d Sess. A275 (1954).

[59]Int. Rev. Code of 1954, § 167(b)(2), (3) and (4). In the floor discussion, Representative Curtis (a member of the Committee on Ways and Means) called the attention of the House to the fact that the combination of the new depreciation methods and the capital gain provisions of § 1231 might well "accentuate" already existing tax advantages. 100 Cong. Rec. 3678 (1954).

[60]S. Rep. No. 1622, 83d Cong., 2d Sess. 27 (1954). This point was also made in the hearings by Undersecretary of the Treasury Folsom. Hearings before the Committee on Finance, United States Senate, 83d Cong., 2d Sess. on H. R. 8300 (Internal Revenue Code of 1954), Part 1, p. 118.

is especially relevant where, as here, the interpretation was not a recondite one known only to tax specialists, but a practical matter familiar to businessmen, lawyers and accountants generally. Since the Congressional membership is largely drawn from and is in constant contact with these groups, it is not surprising that its legislative actions and reports reflect thorough familiarity with the long established interpretation.

Against the above background, the Treasury's shift in position is simply an effort to collect as much tax as possible, without regard to whether the tax has been "authorized by Congress." *Helvering* v. *Griffiths,* 318 U. S. 371, 394 (1943). If the Treasury regards as unsound tax policy the disparity in tax treatment of depreciation deductions and profit on sale of depreciable property, the remedy is to repair to Congress for new legislation. "[S]uch a determination of policy in the administration of the income tax law should be made by Congress, which maintains a Joint Committee of Internal Revenue Taxation charged with the duty of investigating the operation of the federal revenue laws and recommending such legislation as may be deemed desirable." *United States* v. *Nunnally Investment Co.,* 316 U. S. 258, 264 (1942). If the Treasury has decided since 1960[61] that allowance of depreciation for the year of profitable sale is unsound tax policy, it could have asked for statutory disallowance in any of its messages to Congress on the subject of depreciation and capital gain.[62]

The Treasury has become increasingly concerned in recent years over the continued eligibility for capital gain treatment of property subject to new methods of accelerated

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[61]See pp. 21-22, *supra* and 40-41, 47-48, *infra.*
[62]See notes 64, 65 and 67, *infra.*

depreciation.[63] In 1960[64] and again in 1961[65] the Treasury asked Congress to deal with this problem by treating gain on disposition of property as ordinary income to the extent of depreciation taken on the property. Congress partially responded in 1962 by providing that gain on future dispositions of personal property should be so treated to the extent of depreciation taken for years after 1961.[66] In 1963 the Treasury renewed its request that similar treatment be given to real property.[67] Congress again made a limited response by providing for partial recapture of post-1963 depreciation as ordinary income upon future dispositions of real property.[68]

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[63]The Treasury had authorized declining balance depreciation in 1946 (I. T. 3818, 1946-2 C. B. 42); Congress had enacted more rapid depreciation methods in 1954 (Int. Rev. Code of 1954, § 167 (b)(2), (3) and (4)); and the Treasury introduced greatly liberalized depreciation guidelines in 1962 (Rev. Proc. 62-21, 1962-2 C. B. 418). See note 51, *supra* p. 34, for the Treasury's 1947 legislative recommendation for recapture of accelerated depreciation as ordinary income. See also note 59, *supra*, p. 36.

[64]The Budget of the United States Government for the Fiscal Year ending June 30, 1961, at M11; Treasury Department Release A-761, dated February 15, 1960.

[65]Message from the President reprinted in Hearings before the Committee on Ways and Means, House of Representatives, on the President's 1961 Tax Recommendations (H. Doc. No. 140, 87th Cong., 1st Sess.), vol. 1 at 13. The testimony of the Secretary of the Treasury on this recommendation is recorded at pp. 45-46 of those Hearings.

[66]Int. Rev. Code of 1954, § 1245, added by Rev. Act of 1962, § 13(a).

[67]Hearings before the Committee on Ways and Means, House of Representatives, on the President's 1963 Tax Message (H. Doc. No. 43, 88th Cong., 1st Sess.), vol. 1 at 57 (Statement of Secretary of the Treasury).

[68]Int. Rev. Code of 1954, § 1250, added by Rev. Act of 1964, § 231(a). Such recapture was complete for real property held for one year or less; was limited to a sliding-scale fraction of the excess of accelerated over straight-line depreciation for real property held for more than one but less than ten years; and was not provided at all for real property held for ten years or more.

Legislative action in this important area of tax policy is preferable to piecemeal litigation. "Congress can deal with the matter comprehensively, unembarrassed by the limitations of a litigation involving only one phase of a complex problem." *United States* v. *Nunnally Investment Co., supra.* Judicial acceptance of the innovation urged here by the Commissioner would inevitably upset established loss limitations. If useful life and salvage value were redefined to mean the actual period the property is held and the amount realized on its disposition, many capital losses and nonrecognized losses for which Congress has limited or denied deduction would be converted into deductible depreciation. The losses so affected would include loss on sale of nonbusiness depreciable property held for the production of income, now treated as capital loss;[69] losses on sale of business property covered by section 1231 of the Internal Revenue Code that are treated as capital losses because they are exceeded by gains;[70] and losses nonrecognized under various provisions of the Internal Revenue Code.[71] The revenue impairment from this conversion of nondeductible losses into deductible depreciation would, of course, continue in the years for which Congress has already provided for recapture of depreciation as ordinary income on sale at a gain by enacting sections 1245 and 1250 of the Internal Revenue Code.

The Commissioner has attempted to limit his overthrow of precedent to the situation in which a gain is realized on

[69] *E.g.,* the race horse in *Whitaker* v. *Commissioner, supra* p. 28.

[70] *E.g.,* a $30,000 loss on sale of a building realized in the same year as a $40,000 gain on sale of a parking lot.

[71] *E.g.,* losses realized during corporate liquidation under section 337 of the Internal Revenue Code, as in the present case, and losses accrued on depreciable property distributed in complete liquidation and then sold, as in *Kimball Gas Products Co.* v. *United States,* note 102, *infra* p. 48.

sale of the depreciable property,[72] but this limitation is untenable under the principle he is urging. If actual sales price is salvage value, this is true whether the sale is profitable or unprofitable. The Commissioner cannot shift from one view to another in the light of "whichever favors the Government" on a particular occasion. *Rosenman* v. *United States,* 323 U. S. 658, 663 (1945).

In both of its recent enactments Congress could validly have provided for recoupment of depreciation taken for periods prior to the year of enactment, but it considered it unwise to disturb existing depreciation patterns so deeply.[73] The Commissioner is asking this Court to do what Congress was unwilling to do. He asks this Court to validate a 1962 change of position[74] that—since Congress has legislated for the future—is almost wholly retroactive. He asks this Court to join him in a rewriting of history in which he has retroactively (1) revoked a 14-year acquiescence in a Tax Court decision allowing the deduction he challenges;[75] (2) reversed a statement of deductibility in a Treasury regulation of 14 years' standing;[76] (3) closed his eyes to the Congressional committee report on which that regulation was based;[77] (4) issued a revenue ruling at odds with 40 years' administrative practice;[78] (5)

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[72]Rev. Rul. 62-92, *infra* at note 99, p. 48.

[73]The statement in the committee reports on the Revenue Act of 1964 to the effect that enactment of section 1250 was not intended to affect the question presented here was nothing more than the traditional Congressional statement of neutrality with respect to current litigation. H. Rep. No. 749, 88th Cong., 1st Sess. 103 (1963); S. Rep. No. 830, 88th Cong., 2d Sess. 133 (1964).

[74]See pp. 47-48, *infra.*

[75]*Wier Long Leaf Lumber Co., supra, acq.* 1948-1 C. B. 3 (withdrawn), *nonacq.* 1962-1 C. B. 5.

[76]T. D. 6825, note 33, *supra* p. 26, amending Treas. Reg. § 1.1238-1.

[77]See pp. 34-35, *supra.*

[78]Rev. Rul. 62-92, *infra* at note 99, p. 48. See pp. 18-29, *supra.*

ignored a large body of consistent judicial authority;[79] and (6) disregarded well articulated Congressional policy.[80]

This attempt at retroactive administrative legislation in defiance of the well settled rule should be rejected.

III. Abandonment of the Principle that Depreciation Is Allowable for the Year of Sale Is Not Warranted by *Cohn* v. *United States*.

For the convenience of the Court we shall now trace the drastic departure of the Commissioner and the Second Circuit from a rule adopted, reaffirmed, accepted and relied on for more than 40 years. We begin with *Cohn* v. *United States,* 259 F. 2d 371 (6th Cir. 1958), on which both the Commissioner[81] and the Second Circuit (R. 78-79) rely to justify their surprising improvisation.

The taxpayers in *Cohn* equipped and operated three flight-training schools during World War II under contracts with the Army Air Corps terminable by it on 30 days' notice. 259 F. 2d at 373. Two of the schools were opened in 1941 and the third in 1942. Late in 1942 the taxpayers, after learning from discussions with Air Corps personnel that the schools would probably not be used beyond 1944, estimated that the useful economic life of their $360,000 of movable equipment would end on December 31, 1944. For the years 1942, 1943 and 1944 they computed depreciation on the basis of such estimated useful life and a zero salvage value.[82] Late in 1944 the contracts were in fact terminated, the schools were closed, and the equipment was sold at auction. Because of wartime shortages and price

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[79]See pp. 18-29, *supra.*

[80]See pp. 29, 32-36, *supra.*

[81]Rev. Rul. 62-92, *infra* note 99, p. 48. See also R. 11.

[82]For simplicity we shall discuss the *Cohn* case in terms of the calendar years 1942, 1943 and 1944. That case actually involved fiscal years of three partnerships ending with different months of the years 1942-1945.

increases the equipment brought about $140,000 more than its cost as depreciated by the taxpayers.

The Commissioner disallowed about $170,000 of the 1942, 1943 and 1944 depreciation deductions by assigning useful lives of 5 years and 10 years to different classes of equipment, and the taxpayers sued in the district court for refund of the resulting additional taxes. 259 F. 2d at 374-375. The district court, while upholding the taxpayers' estimate of useful life, held that salvage value had to be taken into consideration. The district court found salvage value to be an amount equal to 10 percent of cost (about $36,000) for the purpose of determining 1942 and 1943 depreciation, but increased it to an amount equal to the sales price received on auction (about $185,000) for the purpose of determining 1944 depreciation.

The taxpayers appealed to the Sixth Circuit from the finding of the district court as to salvage value for 1944 only. The taxpayers contended that the district court, having fixed salvage value in determining 1942 and 1943 depreciation, had committed an error of law in adjusting such salvage value upward in determining 1944 depreciation.[83] The Government replied that salvage value that was obviously in error could be corrected for any taxable year in the light of conditions then known to exist.[84] The Sixth Circuit took up first this question of law and decided it for the Government. Under the circumstances of the case, the taxpayers having put in issue in the district court the depreciation deductions claimed by them and disallowed by the Commissioner, "the District Judge was not in error as a matter of law in considering both useful life and salvage value." 259 F. 2d at 379.

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[83]Appellants' Brief, p. 22, in *Cohn* v. *United States.*

[84]Appellee's Brief, p. 20, in *Cohn* v. *United States.*

Having decided this question of law, the Sixth Circuit faced the factual question of whether the district court had correctly determined the amount of the contested salvage value. The taxpayers argued that the district court had increased salvage value merely because of the appreciation in value reflected in the sales price, and that such increase was erroneous and in conflict with the decisions in *Thomas Goggan & Bro., supra* p. 27, and *Wier Long Leaf Lumber Co., supra* pp. 23-25.[85] The Government argued in reply: The "question of the proper amount of estimable salvage value" is "clearly one of fact."[86] The district court did not change salvage value "*solely* because of changes in price levels."[87] "[T]here were other circumstances which indicated that a reasonably estimable salvage value existed far in excess of . . . ten percent of cost."[88] "The issue is not . . . whether mere appreciation in value, due to extraneous causes (i.e., wartime shortages and buying restrictions), justifies the adjustment of salvage values in the year the property is sold."[89] The Government admitted that the Board of Tax Appeals had held in the *Goggan* case that the difference between depreciated cost and amount realized "would not, *by itself* and without evidence of actual usage, be sufficient evidence" to warrant revision of salvage value; but, the Government reiterated, "the court below did not base [its] determination on the sale price alone."[90] Turning to the *Wier* case, the Government admitted that the Tax Court had held that the profitable price received upon the sale of the automobiles did not "by itself" preclude depreciation for the year of sale. "Once again," the Government added,

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[85]Appellants' Brief, pp. 12, 15-17, in *Cohn* v. *United States.*
[86]Appellee's Brief, p. 14, in *Cohn* v. *United States.*
[87]*Id.,* p. 27. Emphasis in original.
[88]*Ibid.*
[89]*Id.,* p. 28.
[90]*Id.,* p. 29. Emphasis in original.

"the sales price of the movable assets was not the sole basis of the District Court's finding in this case."[91] The Government then cited a number of cases in which, it contended, "there were, as here, factors in addition to the actual sales price of the assets upon which the reasonableness of the estimates was based."[92]

Again and again the Government on brief in the Sixth Circuit urged that the district court had made nothing more than a narrow finding on all the facts of the case that was not clearly erroneous.[93] For example, the Government responded as follows to the taxpayers' contention that the equation of salvage value to sales price would obviate the Congressional purpose in granting capital gain treatment to sales of depreciable property:

> "We submit that the District Court did no more than find that the reasonably estimable salvage value was, on the facts of this case, equal to the amounts actually received on the sale of the assets involved. The finding was solely predicated on the facts of this case and, on a different set of facts, it is, of course, possible that an entirely different finding would result. The District Court did not bind itself to find in all cases that reasonably estimable salvage value must be equal to the actual salvage value and the Government does not so contend. The conclusions of the court in this respect . . . must be read

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[91] *Id.*, pp. 29-30.

[92] *Id.*, p. 31. The other factors in the *Cohn* case, said the Government, included the "shortages at the time of the purchase of the goods; the prospect that the shortages would increase as the war continued; the non-specialized nature of the assets"; the taxpayers' realization that they would dispose of the equipment long before the expiration of its intrinsic useful life; and the sales prices other schools were obtaining on auctions of similar equipment. *Id.*, pp. 15-17, 27, 34.

[93] *Id.*, pp. 11, 14, 18, 20, 21, 28, 32, 34.

> in conjunction with the basic finding of the court . . . that, in this case, the reasonably estimable salvage value was equal to the actual value. This fact was merely corroborated by the experience shown in the actual sales."[94]

The Sixth Circuit clearly showed in its opinion that it regarded the amount of salvage value as a factual determination, involving no question of law. Accepting the Government's argument that it was being asked to do nothing more than sustain a finding of fact as not clearly erroneous, the Sixth Circuit concluded that the district court's "findings of fact with respect to salvage value . . . are not clearly erroneous and must be sustained." 259 F. 2d at 379.

Three conclusions are immediately clear. First, the Sixth Circuit was not asked to hold—and did not hold—that the sale of depreciable property at a profit bars depreciation for the year of sale as a matter of law. The Commissioner is attempting here to convert the Sixth Circuit's narrow factual holding into a novel and erroneous legal principle the existence of which the Government denied again and again in its Sixth Circuit brief.

Secondly, the district court's equation of salvage value with the amount realized upon sale of the equipment "at or near the end of [its] useful life" (259 F. 2d at 378) does not establish a broad rule that every sale of property—no matter when and under what circumstances made—yields a sales price equal to salvage value. The Tax Court and the Eighth Circuit, realizing the importance of this distinction, have recently disapproved the Commissioner's treatment of sales price realized in the middle of useful life as salvage value. See the discussion of *Macabe Co., infra* page 50, and *United States* v. *S & A Co., infra* page 52.

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[94] *Id.*, p. 32.

Thirdly, to the extent that the *Cohn* case may be read as the Commissioner and the Second Circuit have read it, it is wrong. The error lies in the district court's assignment of a \$36,000 salvage value to the equipment for the purpose of computing 1942 and 1943 depreciation and a \$185,000 salvage value for 1944 depreciation. If, as the Government argued to the Sixth Circuit, the salvage value of about 50 percent of cost was foreseeable from the outset because of the limited period of usefulness of the property to the taxpayers and the prospect that they would dispose of it while it was in good condition and during a period of wartime shortages—then the higher salvage value should have been used from the beginning. However, if the 10 percent salvage value was reasonable at the outset, then it should not have been adjusted upward. Such upward adjustment of fairly established salvage value to reflect a later unanticipated increase in price levels—whether or not realized by sale—violates every precedent.[95]

This error on the part of the district court should not be lightly attributed to the Sixth Circuit. The Sixth Circuit had only partial jurisdiction of the matter, because neither party had asked it to review the correctness of the district court's determination of salvage value for 1942 and 1943. Since the Sixth Circuit gave no explanation of its one-sentence affirmance of the district court's finding of fact with respect to salvage value for 1944, various inferences are possible. That the Sixth Circuit intended *sub silentio* to disagree with the *Wier* and *Goggan* decisions, which were adequately briefed by the taxpayers and conceded by the Government to be correct statements of law,[96] is the most farfetched of these inferences. Although the Sixth Circuit discussed the difference between annual adjustments to sal-

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[95]See Parts I and II of our argument, pp. 12-41, *supra*.
[96]See pp. 43-45, *supra*.

vage value and a final adjustment in the year of sale, it did so for the very limited purpose of dealing with the taxpayers' argument that annual adjustments would be administratively costly and undesirable. 259 F. 2d at 378. Had the Sixth Circuit intended to initiate a legal principle at odds with more than four decades of administrative, judicial and legislative history, it would have plainly said so.

Not even the Commissioner saw a new legal approach in the *Cohn* decision for several years after it was rendered. The Commissioner allowed depreciation in the year of profitable sale to the taxpayers involved in the *Massey* and *Hertz* cases, *supra* p. 21, decided by this Court in 1960, two years after *Cohn*. In those cases, which held that estimates of useful life and salvage value must reflect the taxpayer's established policy of disposition, this Court recited without disapproving comment the fact of the Commissioner's allowances, while aware of the *Cohn* decision. 364 U. S. 94-95, 117-118.

Such allowances were not through oversight, for the Commissioner stated on brief in this Court his view that such depreciation was allowable: "If salvage value should exceed reasonable expectation—if, for example, the value of used cars should suddenly increase as a result of wartime conditions—realization of capital gain would not show that the method of computing depreciation was impermissible."[97] He added that, consequently, he did not "contend for a hindsight determination of the actual period of usefulness to the taxpayer or of salvage value."[98] Understandably, Mr. Justice Harlan stated in his opinion dissenting in *Massey* and concurring in *Hertz* that "even the Commissioner does not contend that a taxpayer who *hap-*

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[97] Petitioner's Brief, p. 17, in *Commissioner* v. *Evans, supra* note 21, p. 21.
[98] *Id.*, p. 19.

pens to dispose of some asset before its physical exhaustion must depreciate it on a useful life equal to the time it was actually held." 364 U. S. at 113 (emphasis in original).

The Commissioner, like everyone else, still held at the time of the *Massey* and *Hertz* decisions to the established view that depreciation is allowable in the year of profitable sale. His decision to attempt to rewrite history was made later, and was not announced until June of 1962.[99] He relied in his announcement exclusively on the *Cohn, Massey* and *Hertz* decisions for his newly improvised legal doctrine, even though those decisions had all been made in reliance on his statements in his briefs that there was no such doctrine. The support the Commissioner looks for in those decisions is obviously not there.

IV. Recent Cases Continue to Allow Depreciation for the Year of Profitable Sale.

The Commissioner's repudiation of both logic and history has been disapproved by eight of the ten courts that have considered it. The Eighth Circuit,[100] the Tax Court[101] and six district courts[102] have all found it erroneous. Only a

[99] T. I. R. 374, dated June 7, 1962 (the day before the trial of this case in the Tax Court (R. 26)), later republished as Rev. Rul. 62-92, 1962 1 C. B. 29.

[100] *United States* v. *S & A Co.*, 338 F. 2d 629 (8th Cir. 1964), cert. applied for.

[101] *Macabe Co.*, 42 T. C. 1105 (1964), on appeal to Ninth Circuit, and cases cited in notes 106-110, *infra*.

[102] *Wyoming Builders, Inc.* v. *United States*, 227 F. Supp. 534 (D. Wyo. 1964), on appeal to Tenth Circuit; *Occidental Loan Co.* v. *United States*, 235 F. Supp. 519 (S. D. Calif. 1964), on appeal to Ninth Circuit; *Mountain States Mixed Feed Co.* v. *United States*, 65-2 USTC ¶ 9551 (D. Colo. 1965); *Motorlease Corp.* v. *United States*, 215 F. Supp. 356 (D. Conn. 1963), *rev'd*, 334 F. 2d 617 (2d Cir. 1964), cert. applied for; *Kimball Gas Products Co.* v. *United States*, 63-2 USTC ¶ 9507 (W. D. Tex. 1962), on appeal to Fifth Circuit; *S & A Co.* v. *United States*, 218 F. Supp. 677 (D. Minn. 1963), *aff'd*, 338 F. 2d 629 (8th Cir. 1964), cert. applied for.

divided Second Circuit[103] and one district court[104] have held for the Commissioner—and these decisions were made during the period of, and were perhaps influenced by, the Tax Court's temporary allegiance to the Commissioner's novel doctrine.

The Tax Court, after initially embracing the Commissioner's new position in a case where the issue was not sufficiently important to be briefed by the taxpayer,[105] uncritically followed that decision in the present case. (R. 2-18.) Thereafter, the Tax Court, on more thorough consideration, squarely rejected the Commissioner's view in a decision reviewed by the entire court, ***Macabe Co., supra*** note 101. In *Macabe* the taxpayer sold an office building near the end of the ninth year of its estimated 33⅓ year useful life for an amount exceeding the building's adjusted basis at the beginning of the year of sale. 42 T. C. at 1106-1108. The taxpayer had computed its annual depreciation allowance for the building under the straight-line method and a zero salvage value, which the Tax Court found to be reasonable. *Ibid.* The Commissioner disallowed such depreciation for the year of sale solely by using the sales price as salvage value.

The Tax Court rejected the Commissioner's equation of sales price with salvage value "because it fails to take

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[103]Judge Moore dissented from the decision below. Judge Waterman dissented from the decision of another panel of the Second Circuit in *United States* v. *Motorlease Corp.*, 334 F. 2d 617 (2d Cir. 1964), cert. applied for.

[104]*Killebrew* v. *United States*, 64-2 USTC ¶ 9728 (E. D. Tenn. 1964).

[105]*Randolph D. Rouse*, 39 T. C. 70 (1962). The principal issue in the *Rouse* case was whether rental houses were depreciable, and the secondary issue was the proper method of computing depreciation for all years. The taxpayer did not regard the question of year-of-sale depreciation as a separate issue worthy of mention; did not object to the Commissioner's erroneous one-sentence summary of the *Cohn* case; and did not even cite the *Wier* case or any of the other applicable precedents.

into account the distinction between (1) the concept of 'depreciation' or the gradual exhaustion of property and (2) the concepts of 'appreciation' or 'depreciation' in the value of property because of market conditions such as scarcity, inflation, or the like." 42 T. C. at 1109. The "granting of a reasonable allowance for depreciation is a matter separate and distinct from the computation of gain upon the sale of property." *Ibid.* "Depreciation, as that term is used in section 167, occurs through use and the passage of time; such depreciation occurs regardless of market conditions which might otherwise enhance or diminish the value of an asset." *Ibid.* The Tax Court recognized the obvious fact that "the building continued to depreciate in petitioner's hands right up to the time of the sale." *Ibid.*

In disapproving the Commissioner's attempt to equate sales price with salvage value, the Tax Court stated that actual sales proceeds might be evidence of salvage value where property "is sold at or near the end of . . . its useful life to the taxpayer." *Id.* at 1115. Even then, sales price controls only if "the taxpayer fails to establish that all or some specific portion of the sales proceeds resulted from market appreciation, rather than excessive depreciation." *Ibid.* In the case of an unexpected sale in the middle of useful life, however, actual sales price has "little relevance to the amount the property would bring at the end of its useful life." *Ibid.* The "actual sales price would be relevant to salvage value" only "if useful life could be equated with the period for which the taxpayer actually held the property at the time of its sale." *Id.* at 1116. However, "the concept of 'useful life,' is entirely different from that of 'the actual holding period'." *Ibid.*

On the basis of the principles announced in *Macabe*, the Tax Court has since allowed depreciation up to the date

of profitable sale in the case of construction equipment sold as part of a business,[106] rental automobiles,[107] and a shopping center, an Air Force housing project and rental real estate.[108] The Tax Court has denied depreciation in the year of sale only where the taxpayer failed to prove that its estimates of useful life and salvage value were reasonable,[109] or where no revision of a first year's estimate was involved because the taxpayer arranged to sell the property in the year of acquisition.[110]

The Eighth Circuit likewise disapproved the Commissioner's new position in *United States* v. *S & A Co., supra* note 100, in which the taxpayer, a manufacturer of outboard motors, had made a profitable sale of its entire business. Prior to the sale, the taxpayer had intended to use the depreciable property of the business for its entire economic life, which had not terminated at the time of the sale. 338 F. 2d at 631. The Eighth Circuit allowed in full the depreciation deductions computed by the taxpayer for the year of sale under the reasonable estimates used for prior years.

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[106] *Harry Trotz*, 43 T. C. 127 (1964), on appeal to Tenth Circuit; compare *C. L. Nichols*, 43 T. C. 135 (1964), on appeal to Eighth Circuit.

[107] *Holder Drive-Ur-Self, Inc.*, 43 T. C. 202 (1964); *Harry Friend*, T. C. Memo. 1965-35, 25 CCH T. C. Memo. 192 (1965), on appeal to Fourth Circuit.

[108] *Palmaneda Adams*, T C. Memo. 1964-286, 23 CCH T. C. Memo. 1743 (1964), on appeal to Sixth Circuit; *Moses Lake Homes, Inc.*, T. C. Memo. 1964-289, 23 CCH T. C. Memo. 1756 (1964), on appeal to Ninth Circuit; *Herschel M. Hays*, T. C. Memo. 1965-213, 25 CCH T. C. Memo. 1103 (1965).

[109] *Engineers Limited Pipeline Co.*, 44 T. C. ——, No. 25 (1965); *L. M. Lockhart*, 43 T. C. 776 (1965), on appeal to Ninth Circuit; *Bell Lines, Inc.*, 43 T. C. 358 (1964); *Specialty Paper and Board Co.*, T. C. Memo. 1965-208, 24 CCH T. C. Memo. 1085 (1965); *The Covered Wagon, Inc.*, T. C. Memo. 1965-79, 24 CCH T. C. Memo. 427 (1965); *Melvon C. Miller*, T. C. Memo. 1964-305, 23 CCH T. C. Memo. 1888 (1964).

[110] *Smith Leasing Co.*, 43 T. C. 37 (1964), on appeal to Fifth Circuit.

In denying the automatic equivalence of sales price with salvage value asserted by the Commissioner, the court said: "Depreciation and capital gain or loss are separate concepts in the income tax law although, of course, the one necessarily affects the other. The former in theory rests on a base independent of market fluctuations. The latter is aimed at those fluctuations. This dichotomy is inherent in the statute. It is defeated and ignored if depreciation is inevitably to be tied to sale price." 338 F. 2d at 641.

The Eighth Circuit, like the Tax Court in *Macabe,* held that the unanticipated sale of depreciable property in the middle of its useful life does not reduce its useful life to the actual holding period and that the sales price of the property does not constitute its salvage value. Salvage value is the amount expected to be realized at the end of useful life, the court held, not any sales price actually obtained. "There is no absolute identity of salvage value with sales price. The one is not necessarily equivalent to the other. Neither the statute nor the regulations equate them or make an exception out of the sale year." 338 F. 2d at 640.

In accord with the Tax Court and the Eighth Circuit, five district courts (in addition to the Minnesota district court affirmed by the Eighth Circuit in the *S & A* case) have rejected the Commissioner's new position and allowed depreciation up to the date of profitable sale or other disposition in cases involving sales of rental automobiles,[111] rental houses,[112] an Air Force housing project,[113] machinery, equipment and buildings used in a milling and feed business,[114] and a gas processing plant and gathering system.[115]

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[111] *Motorlease Corp.* v. *United States, supra* note 102.

[112] *Occidental Loan Co.* v. *United States, supra* note 102.

[113] *Wyoming Builders, Inc.* v. *United States, supra* note 102.

[114] *Mountain States Mixed Feed Co.* v. *United States, supra* note 102.

[115] *Kimball Gas Products Co.* v. *United States, supra* note 102.

The great weight of current judicial authority thus continues to adhere to the traditional view that depreciation is allowable for the year of profitable sale.

V. The Taxpayer Is Entitled to the Reasonable Allowance Claimed by It for Depreciation of the *Feuer*.

The facts in this case are undisputed and the issue is purely one of law.[116] We have shown that, under the correct rule of law, reasonably established salvage value is not subject to change because of changes in market levels. Under this rule, the taxpayer is entitled to the depreciation claimed for the *Feuer* for 1957, because the correctness of the salvage value established for the *Feuer* is uncontroverted.[117]

The essential facts are that the taxpayer owned and operated the *Feuer* in its profitable shipping business. (R. 3.) Against its gross profit of almost $300,000 from operation of the *Feuer* during 1957, the taxpayer deducted about $135,000 for depreciation of the ship. (R. 7.) This depreciation was at the rate established by a ruling letter obtained from the Internal Revenue Service at the time of the taxpayer's purchase of the *Feuer* in 1955. (R. 4.) The taxpayer, receiving an unsolicited attractive offer for the *Feuer* during the Suez Canal crisis, sold it in December 1957 at a substantial profit. (R. 5-6.)

The correctness of the estimate of a three-year useful economic life and a $54,000 salvage value for the *Feuer*

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[116]The Commissioner agrees that the sole question is one of law (Respondent's Brief, p. 5, in the Second Circuit in this case) and that the facts are undisputed (*id.* at p. 7).

[117]There is a suggestion in the *Macabe* opinion, *supra,* at 1110-1111, 1115, that the decision below, although unsound in principle, might be justified on the ground that the taxpayer failed to prove that the gain on sale was not attributable to excessive depreciation. This statement reflects a failure to examine the record in this case, which clearly establishes the reasonableness of the taxpayer's estimates of useful life and salvage value.

was established by the ruling letter issued by the Commissioner's expert Engineering and Valuation Branch. (R. 4.) The Tax Court found that the Commissioner had never changed the ruling letter (R. 5) and had never questioned the estimated three-year life. (R. 14.) The Tax Court also summarized in its findings the extensive evidence presented by the taxpayer in support of the correctness of that estimated useful life. (R. 8-10.)

The Tax Court further stated that the taxpayer had presented extensive evidence supporting the correctness at the end of 1957 of the estimated $54,000 salvage value based on scrap prices. (R. 11, 14.) Since the Tax Court found that the taxpayer did not follow the practice of using ships for a short time and then reselling them (R. 6, 14), scrap value was the proper measure of salvage value. *Massey Motors, Inc.* v. *United States, supra* p. 21, at 96. The Tax Court also found that the increase in the market value of the *Feuer* was "due to economic and market conditions" resulting from the Suez Canal crisis (R. 6), and the Second Circuit recognized that "the increment in the *Feuer's* value resulted from a fortuity normally associated with capital gain." (R. 81.)

These undisputed facts show that the taxpayer would be entitled to depreciation in the amount claimed even if this Court were to adopt the view that salvage value could be adjusted to a sales price received "at or near the end of the useful life of the asset."[118] The price received on the unanticipated sale of the *Feuer* in the middle of its useful life sheds no light on the amount of salvage value realizable at the end of its useful life.[119] On expiration of that useful life, the vessel would be obsolete and saleable only for scrap.

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[118] *Cohn* v. *United States,* 259 F. 2d at 378.

[119] See pp. 50 and 52, *supra.*

Since the disallowance of depreciation on the *Feuer* is grounded solely on an erroneous conception of law, the decision below should be reversed. "To remand the cause for further findings would be futile. The Board could not properly find anything which would assist the Commissioner's cause." *General Utilities Co.* v. *Helvering,* 296 U. S. 200, 207 (1935).

CONCLUSION

The decision of the Court of Appeals is erroneous and should be reversed.

Respectfully submitted,

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APPENDICES

APPENDIX A

Statutes

Sec. 167.* Depreciation.

(a) General Rule.—There shall be allowed as a depreciation deduction a reasonable allowance for the exhaustion, wear and tear (including a reasonable allowance for obsolescence)—

(1) of property used in the trade or business, or

(2) of property held for the production of income.

(b) Use of Certain Methods and Rates.—For taxable years ending after December 31, 1953, the term "reasonable allowance" as used in subsection (a) shall include (but shall not be limited to) an allowance computed in accordance with regulations prescribed by the Secretary or his delegate, under any of the following methods:

(1) the straight line method. . . .

(f) Basis for Depreciation.—The basis on which exhaustion, wear and tear, and obsolescence are to be allowed in respect of any property shall be the adjusted basis provided in section 1011 for the purpose of determining the gain on the sale or other disposition of such property.

Treasury Regulations

§ 1.167(a)-1. Depreciation in General.

(a) *Reasonable allowance.* Section 167 (a) provides that a reasonable allowance for the exhaustion, wear and

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*As in effect during the calendar year 1957. Subsection 167(f) has since been relettered as subsection 167(g).

tear, and obsolescence of property used in the trade or business or of property held by the taxpayer for the production of income shall be allowed as a depreciation deduction. The allowance is that amount which should be set aside for the taxable year in accordance with a reasonably consistent plan (not necessarily at a uniform rate), so that the aggregate of the amounts set aside, plus the salvage value, will, at the end of the estimated useful life of the depreciable property, equal the cost or other basis of the property as provided in section 167(g) and § 1.167(g)-1. An asset shall not be depreciated below a reasonable salvage value under any method of computing depreciation. However, see section 167(f) and § 1.167(f)-1 for rules which permit a reduction in the amount of salvage value to be taken into account for certain personal property acquired after October 16, 1962. See also paragraph (c) of this section for definition of salvage. The allowance shall not reflect amounts representing a mere reduction in market value. See section 179 and § 1.179-1 for a further description of the term "reasonable allowance."

(b) *Useful life.* For the purpose of section 167 the estimated useful life of an asset is not necessarily the useful life inherent in the asset but is the period over which the asset may reasonably be expected to be useful to the taxpayer in his trade or business or in the production of his income. This period shall be determined by reference to his experience with similar property taking into account present conditions and probable future developments. Some of the factors to be considered in determining this period are (1) wear and tear and decay or decline from natural causes, (2) the normal progress of the art, economic changes, inventions, and current developments within the industry and the taxpayer's trade or business, (3) the climatic and other local conditions peculiar to the taxpayer's trade or business, and (4) the taxpayer's policy as to re-

pairs, renewals, and replacements. Salvage value is not a factor for the purpose of determining useful life. If the taxpayer's experience is inadequate, the general experience in the industry may be used until such time as the taxpayer's own experience forms an adequate basis for making the determination. The estimated remaining useful life may be subject to modification by reason of conditions known to exist at the end of the taxable year and shall be redetermined when necessary regardless of the method of computing depreciation. However, estimated remaining useful life shall be redetermined only when the change in the useful life is significant and there is a clear and convincing basis for the redetermination. For rules covering agreements with respect to useful life, see section 167(d) and § 1.167(d)-1.

(c) *Salvage.* (1) Salvage value is the amount (determined at the time of acquisition) which is estimated will be realizable upon sale or other disposition of an asset when it is no longer useful in the taxpayer's trade or business or in the production of his income and is to be retired from service by the taxpayer. Salvage value shall not be changed at any time after the determination made at the time of acquisition merely because of changes in price levels. However, if there is a redetermination of useful life under the rules of paragraph (b) of this section, salvage value may be redetermined based upon facts known at the time of such redetermination of useful life. Salvage, when reduced by the cost of removal, is referred to as net salvage. The time at which an asset is retired from service may vary according to the policy of the taxpayer. If the taxpayer's policy is to dispose of assets which are still in good operating condition, the salvage value may represent a relatively large proportion of the original basis of the asset. However, if the taxpayer customarily uses an asset until its inherent useful life has been substantially ex-

hausted, salvage value may represent no more than junk value. Salvage value must be taken into account in determining the depreciation deduction either by a reduction of the amount subject to depreciation or by a reduction in the rate of depreciation, but in no event shall an asset (or an account) be depreciated below a reasonable salvage value. See, however, paragraph (a) of § 1.167(b)-2 for the treatment of salvage under the declining balance method, and § 1.179-1 for the treatment of salvage in computing the additional first-year depreciation allowance. The taxpayer may use either salvage or net salvage in determining depreciation allowances but such practice must be consistently followed and the treatment of the costs of removal must be consistent with the practice adopted. For specific treatment of salvage value, see §§ 1.167(b)-1, 1.167(b)-2, and 1.167(b)-3. When an asset is retired or disposed of, appropriate adjustments shall be made in the asset and depreciation reserve accounts. For example, the amount of the salvage adjusted for the costs of removal may be credited to the depreciation reserve.

(2) For taxable years beginning after December 31, 1961, and ending after October 16, 1962, see section 167(f) and § 1.167(f)-1 for rules applicable to the reduction of salvage value taken into account for certain personal property acquired after October 16, 1962.

§ 1.167(a)-8. RETIREMENTS. (a) *Gains and losses on retirements.* For the purposes of this section the term "retirement" means the permanent withdrawal of depreciable property from use in the trade or business or in the production of income. The withdrawal may be made in one of several ways. For example, the withdrawal may be made by selling or exchanging the asset, or by actual abandonment. In addition, the asset may be withdrawn from such productive use without disposition as, for example, by being

placed in a supplies or scrap account. The tax consequences of a retirement depend upon the form of the transaction, the reason therefor, the timing of the retirement, the estimated useful life used in computing depreciation, and whether the asset is accounted for in a separate or multiple asset account. Upon the retirement of assets, the rules in this section apply in determining whether gain or loss will be recognized, the amount of such gain or loss, and the basis for determining gain or loss:

(1) Where an asset is retired by sale at arm's length, recognition of gain or loss will be subject to the provisions of sections 1002, 1231, and other applicable provisions of law.

(2) Where an asset is retired by exchange, the recognition of gain or loss will be subject to the provisions of sections 1002, 1031, 1231, and other applicable provisions of law.

(3) Where an asset is permanently retired from use in the trade or business or in the production of income but is not disposed of by the taxpayer or physically abandoned (as, for example, when the asset is transferred to a supplies or scrap account), gain will not be recognized. In such a case loss will be recognized measured by the excess of the adjusted basis of the asset at the time of retirement over the estimated salvage value or over the fair market value at the time of such retirement if greater, but only if—

(i) The retirement is an abnormal retirement, or

(ii) The retirement is a normal retirement from a single asset account (but see paragraph (d) of this section for special rule for item accounts), or

(iii) The retirement is a normal retirement from a multiple asset account in which the depreciation rate was

based on the maximum expected life of the longest lived asset contained in the account.

(4) Where an asset is retired by actual physical abandonment (as, for example, in the case of a building condemned as unfit for further occupancy or other use), loss will be recognized measured by the amount of the adjusted basis of the asset abandoned at the time of such abandonment. In order to qualify for the recognition of loss from physical abandonment, the intent of the taxpayer must be irrevocably to discard the asset so that it will neither be used again by him nor retrieved by him for sale, exchange, or other disposition.

Experience with assets which have attained an exceptional or unusual age shall, with respect to similar assets, be disregarded in determining the maximum expected useful life of the longest lived asset in a multiple asset account. For example, if a manufacturer establishes a proper multiple asset account for 50 assets which are expected to have an average life of 30 years but which will remain useful to him for varying periods between 20 and 40 years, the maximum expected useful life will be 40 years, even though an occasional asset of this kind may last 60 years.

(b) *Definition of normal and abnormal retirements.* For the purpose of this section the determination of whether a retirement is normal or abnormal shall be made in the light of all the facts and circumstances. In general, a retirement shall be considered a normal retirement unless the taxpayer can show that the withdrawal of the asset was due to a cause not contemplated in setting the applicable depreciation rate. For example, a retirement is considered normal if made within the range of years taken into consideration in fixing the depreciation rate and if the asset has reached a condition at which, in the normal course of events,

the taxpayer customarily retires similar assets from use in his business. On the other hand, a retirement may be abnormal if the asset is withdrawn at an earlier time or under other circumstances, as, for example, when the asset has been damaged by casualty or has lost its usefulness suddenly as the result of extraordinary obsolescence.

(c) *Basis of assets retired.* The basis of an asset at the time of retirement for computing gain or loss shall be its adjusted basis for determining gain or loss upon a sale or other disposition as determined in accordance with the provisions of section 1011 and the following rules:

(1) In the case of a normal retirement of an asset from a multiple asset account where the depreciation rate is based on average expected useful life, the term "adjusted basis" means the salvage value estimated in determining the depreciation deduction in accordance with the provisions in paragraph (c) of § 1.167(a)-1.

(2) In the case of a normal retirement of an asset from a multiple asset account in which the depreciation rate was based on the maximum expected life of the longest lived asset in the account, the adjustment for depreciation allowed or allowable shall be made at the rate which would have been proper if the asset had been depreciated in a single asset account (under the method of depreciation used for the multiple asset account) using a rate based upon the maximum expected useful life of that asset, and

(3) In the case of an abnormal retirement from a multiple asset account the adjustment for depreciation allowed or allowable shall be made at the rate which would have been proper had the asset been depreciated in a single asset account (under the method of depreciation used for the multiple asset account) and using a rate based upon either the average expected useful life or the maximum

expected useful life of the asset, depending upon the method of determining the rate of depreciation used in connection with the multiple asset account.

. . . .

§ 1.167(a)-9. OBSOLESCENCE. The depreciation allowance includes an allowance for normal obsolescence which should be taken into account to the extent that the expected useful life of property will be shortened by reason thereof. Obsolescence may render an asset economically useless to the taxpayer regardless of its physical condition. Obsolescence is attributable to many causes, including technological improvements and reasonably foreseeable economic changes. Among these causes are normal progress of the arts and sciences, supersession or inadequacy brought about by developments in the industry, products, methods, markets, sources of supply, and other like changes, and legislative or regulatory action. In any case in which the taxpayer shows that the estimated useful life previously used should be shortened by reason of obsolescence greater than had been assumed in computing such estimated useful life, a change to a new and shorter estimated useful life computed in accordance with such showing will be permitted. No such change will be permitted merely because in the unsupported opinion of the taxpayer the property may become obsolete. For rules governing the allowance of a loss when the usefulness of depreciable property is suddenly terminated, see § 1.167(a)-8. If the estimated useful life and the depreciation rates have been the subject of a previous agreement, see section 167(d) and § 1.167(d)-1.

§ 1.167(a)-10. WHEN DEPRECIATION DEDUCTION IS ALLOWABLE. (a) A taxpayer should deduct the proper depreciation allowance each year and may not increase his depreciation allowances in later years by reason of his

failure to deduct any depreciation allowance or of his action in deducting an allowance plainly inadequate under the known facts in prior years. The inadequacy of the depreciation allowance for property in prior years shall be determined on the basis of the allowable method of depreciation used by the taxpayer for such property or under the straight line method if no allowance has ever been claimed for such property. The preceding sentence shall not be construed as precluding application of any method provided in section 167 (b) if taxpayer's failure to claim any allowance for depreciation was due solely to erroneously treating as a deductible expense an item properly chargeable to capital account. For rules relating to adjustments to basis, see section 1016 and the regulations thereunder.

(b) The period for depreciation of an asset shall begin when the asset is placed in service and shall end when the asset is retired from service. A proportionate part of one year's depreciation is allowable for that part of the first and last year during which the asset was in service. However, in the case of a multiple asset account, the amount of depreciation may be determined by using what is commonly described as an "averaging convention" that is, by using an assumed timing of additions and retirements. For example, it might be assumed that all additions and retirements to the asset account occur uniformly throughout the taxable year, in which case depreciation is computed on the average of the beginning and ending balances of the asset account for the taxable year. See example (3) under paragraph (b) of § 1.167(b)-1. Among still other averaging conventions which may be used is the one under which it is assumed that all additions and retirements during the first half of a given year were made on the first day of that year and that all additions and retirements during the second half of the year were made on the first day of the following year. Thus, a full year's depreciation would be

taken on additions in the first half of the year and no depreciation would be taken on additions in the second half. Moreover, under this convention, no depreciation would be taken on retirements in the first half of the year and a full year's depreciation would be taken on the retirements in the second half. An averaging convention, if used, must be consistently followed as to the account or accounts for which it is adopted, and must be applied to both additions and retirements. In any year in which an averaging convention substantially distorts the depreciation allowance for the taxable year, it may not be used.

§1.167(b)-0. METHODS OF COMPUTING DEPRECIATION. (a) *In general.* Any reasonable and consistently applied method of computing depreciation may be used or continued in use under section 167. Regardless of the method used in computing depreciation, deductions for depreciation shall not exceed such amounts as may be necessary to recover the unrecovered cost or other basis less salvage during the remaining useful life of the property. The reasonableness of any claim for depreciation shall be determined upon the basis of conditions known to exist at the end of the period for which the return is made. It is the responsibility of the taxpayer to establish the reasonableness of the deduction for depreciation claimed. Generally, depreciation deductions so claimed will be changed only where there is a clear and convincing basis for a change.

(b) *Certain methods.* Methods previously found adequate to produce a reasonable allowance under the Internal Revenue Code of 1939 or prior revenue laws will, if used consistently by the taxpayer, continue to be acceptable under section 167(a). Examples of such methods which continue to be acceptable are the straight line method, the declining balance method with the rate limited to 150 percent of the applicable straight line rate, and under appropriate circum-

stances, the unit of production method. The methods described in section 167(b) and §§ 1.167(b)-1, 1.167(b)-2, 1.167(b)-3, and 1.167(b)-4 shall be deemed to produce a reasonable allowance for depreciation except as limited under section 167(c) and § 1.167(c)-1. See also § 1.167(e)-1 for rules relating to change in method of computing depreciation.

. . . .

§ 1.167(b)-1. STRAIGHT LINE METHOD. (a) *Application of method.* Under the straight line method the cost or other basis of the property less its estimated salvage value is deductible in equal annual amounts over the period of the estimated useful life of the property. The allowance for depreciation for the taxable year is determined by dividing the adjusted basis of the property at the beginning of the taxable year, less salvage value, by the remaining useful life of the property at such time. For convenience, the allowance so determined may be reduced to a percentage or fraction. The straight line method may be used in determining a reasonable allowance for depreciation for any property which is subject to depreciation under section 167 and it shall be used in all cases where the taxpayer has not adopted a different acceptable method with respect to such property.

. . . .

§ 1.167(g)-1. BASIS FOR DEPRECIATION. The basis upon which the allowance for depreciation is to be computed with respect to any property shall be the adjusted basis provided in section 1011 for the purpose of determining gain on the sale or other disposition of such property. In the case of property which has not been used in the trade or business or held for the production of income and which is thereafter converted to such use, the fair market value on the date of such conversion, if less than the adjusted basis of the property at that time, is the basis for computing depreciation.

APPENDIX B

Statutory Depreciation Provisions, 1909-1965

CORPORATION EXCISE TAX ACT OF 1909.

SEC. 38 (SECOND).

Such net income shall be ascertained by deducting from the gross amount of the income . . . a reasonable allowance for depreciation of property, if any . . . .

REVENUE ACT OF 1913.

Sec. IIB (individuals).

[I]n computing net income for the purpose of the normal tax there shall be allowed as deductions . . . a reasonable allowance for the exhaustion, wear and tear of property arising out of its use or employment in the business . . . .

Sec. IIG (corporations).

[N]et income shall be ascertained by deducting from the gross amount of the income . . . a reasonable allowance for depreciation by use, wear and tear of property, if any . . . .

REVENUE ACT OF 1916.

Sec. 5(a) (individuals).

[I]n computing net income . . . there shall be allowed as deductions . . . A reasonable allowance for the exhaustion, wear and tear of property arising out of its use or employment in the business or trade . . . .

Sec. 12(a) (corporations).

[N]et income shall be ascertained by deducting from the gross amount of its income . . . a reasonable allowance for the exhaustion, wear and tear of property arising out of its use or employment in the business or trade . . . .

Revenue Act of 1918.

Sec. 214(a)(8) (individuals).

[I]n computing net income there shall be allowed as deductions . . . A reasonable allowance for the exhaustion, wear and tear of property used in the trade or business, including a reasonable allowance for obsolescence . . . .

Sec. 234(a)(7) (corporations).

[I]n computing the net income . . . there shall be allowed as deductions . . . A reasonable allowance for the exhaustion, wear and tear of property used in the trade or business, including a reasonable allowance for obsolescence . . . .

Revenue Act of 1921, Sec. 214(a)(8) (individuals) and Sec. 234(a)(7) (corporations).

Same as Revenue Act of 1918, Sec. 214(a)(8) and Sec. 234(a)(7).

Revenue Act of 1924, Sec. 214(a)(8) (individuals) and Sec. 234(a)(7) (corporations).

Same as Revenue Act of 1918, Sec. 214(a)(8) and Sec. 234(a)(7).

Revenue Act of 1926, Sec. 214(a)(8) (individuals) and Sec. 234(a)(7) (corporations).

Same as Revenue Act of 1918, Sec. 214(a)(8) and Sec. 234(a)(7).

Revenue Act of 1928, Sec. 23(k).

In computing net income there shall be allowed as deductions . . . A reasonable allowance for the exhaustion, wear and tear of property used in the trade or business, including a reasonable allowance for obsolescence . . . .

Revenue Act of 1932, Sec 23(k).

Same as Revenue Act of 1928, Sec. 23(k).

Revenue Act of 1934, Sec. 23(l).

Same as Revenue Act of 1928, Sec. 23(k).

Revenue Act of 1936, Sec. 23(l).

Same as Revenue Act of 1928, Sec. 23(k).

Revenue Act of 1938, Sec. 23(l).

Same as Revenue Act of 1928, Sec. 23(k).

Internal Revenue Code of 1939, Sec. 23(l), as originally enacted.

Same as Revenue Act of 1928, Sec. 23(k).

Internal Revenue Code of 1939, Sec. 23(l), as retroactively amended by Revenue Act of 1942, Sec. 121(c).

In computing net income there shall be allowed as deductions . . . A reasonable allowance for the exhaustion, wear and tear (including a reasonable allowance for obsolescence)—

(1) of property used in the trade or business, or

(2) of property held for productions of income.

Internal Revenue Code of 1954, Sec. 167(a).

See Appendix A, p. 1a, *supra*.

INDEX

788-820—65——1

CITATIONS

Cases—Continued

Statutes—Continued

In the Supreme Court of the United States

OCTOBER TERM, 1965

No. 23

FRIBOURG NAVIGATION COMPANY, INC., PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR THE RESPONDENT

OPINIONS BELOW

The findings of fact and opinion of the Tax Court (R. 2–18) are not officially reported. The opinion of the Court of Appeals (R. 76–90) is reported at 335 F. 2d 15.

JURISDICTION

The judgment of the Court of Appeals was entered on July 15, 1964 (R. 91). A timely petition for rehearing (R. 92–98) was denied on August 20, 1964 (R. 99–101). The petition for a writ of certiorari was filed on November 13, 1964, and granted on February 1, 1965 (R. 102). This Court has jurisdiction under 28 U.S.C. 1254(1).

QUESTION PRESENTED

Petitioner purchased a ship in 1955 for $469,000 and sold it in late 1957 for $695,500. Thus at the end of 1957 petitioner knew that its use of the ship had cost it nothing. The question presented is whether in these circumstances petitioner is entitled to a depreciation deduction in 1957.

STATUTES AND REGULATIONS INVOLVED

Section 167 of the Internal Revenue Code of 1954:

> (a) There shall be allowed as a depreciation deduction a reasonable allowance for the exhaustion, wear and tear (including a reasonable allowance for obsolescence)—
>
> (1) of property used in the trade or business * * *. [26 U.S.C. 167(a).]

Other pertinent portions of the Internal Revenue Code of 1954 and of the Treasury Regulations on Income Tax (1954 Code) are set forth in the Appendix, *infra*, pp. 49–54.

STATEMENT

On December 21, 1955 petitioner purchased the S.S. *Joseph Feuer,* a used Liberty ship, for $469,000. Prior to purchasing the *Feuer,* petitioner requested and received from the Internal Revenue Service a "letter ruling" stating that the Service would accept straight-line depreciation of the ship based on an estimated useful economic life of three years and an estimated value as scrap steel at the end of that period of $54,000. The letter also stated that it was not a binding agreement under Code Section 167(d)

and the useful life was "subject to such change as subsequent experience may warrant."[1]

In its income tax return for the calendar year 1955 petitioner claimed and was allowed a depreciation deduction for the ten-day period from the date of purchase to the end of the year in the amount of \$3,786.50 (\$469,000 less $\$54{,}000 \div 3 \times {}^{10}\!/_{365}$). In its return for 1956 it claimed and was allowed a depreciation deduction of \$138,585.77 (\$469,000 less \$54,000÷3). As a result of these depreciation deductions, the adjusted cost basis of the *Feuer* at the beginning of 1957 (the taxable year here involved) was \$326,627.73.

The original estimates of the *Feuer's* useful life and salvage value, concededly reasonable when made in 1955, were significantly affected by a scarcity of ships resulting from the Suez crisis of 1956–1957. The blocking of the Suez Canal caused a sharp increase in the value of ships of this type. In mid-1957, petitioner contracted to sell the *Feuer* to the Isbrandtsen Co., and on December 23, 1957, delivered the vessel to its new owner, receiving a price of \$695,500. Thus after using the ship for two of the originally estimated three years, petitioner sold it for a price which not only exceeded petitioner's adjusted cost basis for the *Feuer* at the beginning of 1957, but also was substantially in excess of petitioner's original cost of the ship.

Prior to the sale of the vessel, petitioner adopted a

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[1] Unless otherwise stated, all references are to the Internal Revenue Code of 1954 and the Regulations thereunder.

plan of complete liquidation, which it thereafter completed within 12 months, thus qualifying as a tax-free liquidation under 1954 Code Section 337.

On its 1957 tax return petitioner claimed a depreciation deduction for the *Feuer* in the amount of \$135,367.24 (covering the 357½ days of that year prior to the sale of the vessel) computed on the basis of the original estimates of useful life and salvage value. It reported a capital gain on the sale of the *Feuer* of \$504,239.51 (the difference between the \$695,500 selling price and the ship's adjusted cost basis after reduction by the amount of the claimed 1957 depreciation). Petitioner treated this approximately \$504,000 gain on the sale of the *Feuer* as nontaxable under the provisions of Section 337. The Commissioner disallowed the claimed depreciation deduction for 1957, resulting in a corresponding decrease in the nonrecognizable gain. The Tax Court sustained the Commissioner's determination, and the court of appeals affirmed, one judge dissenting. (R. 2–18, 76–90.)

SUMMARY OF ARGUMENT

Petitioner sold the S.S. *Feuer* in December 1957 for more than its original cost. We submit that since at the end of 1957, when petitioner computed its depreciation for that year, it knew that its use of the ship during 1957 had cost it nothing, it is not entitled to a deduction for depreciation. If petitioner were permitted a \$135,000 depreciation deduction, its ordinary income would be reduced by that amount and its gain on sale of the *Feuer* correspondingly increased. Be-

cause petitioner has elected a tax-free 12-month liquidation, however, its gain on sale of the *Feuer* is not taxable.

I

Depreciation is designed to give a taxpayer periodic deductions, the total of which will be as nearly equal as possible to his actual net cost of using an asset. Until the taxpayer disposes of the asset, however, he does not know its actual net cost. In some cases he may obtain only a nominal junk price for it; in others (such as here) he may sell it for more than its original purchase price. In order to give the taxpayer depreciation deductions in the tax periods when the asset is contributing to income, certain estimates are employed. The taxpayer estimates the length of time he will use the asset and the price he will receive on resale at the end of that period. He then computes the asset's estimated net cost and the period over which he should deduct that net cost.

These estimates are, of course, only a subtitute for the actual facts. In order to achieve the overriding purpose of depreciation—giving the taxpayer periodic deductions which are, in total, as close to actual net cost as possible—the estimates should be revised if a substantial change in conditions makes them materially inaccurate. The Regulations provide that the reasonableness of any claim for depreciation will be judged in light of the conditions existing at the end of the tax year in which the deduction is taken and that a taxpayer may never knowingly deduct more depreciation than the net cost of an asset. Treas. Regs. §§ 1.167(b)–0, 1.167(a)–1(a), (c). This, we submit, requires a taxpayer to revise his estimates if at any time they become unreasonable.

The Regulations state a specific example of when such a revision is necessary: If the conditions existing *at the end of any tax year* indicate that the period during which the taxpayer will use an asset is significantly different from his original estimate, he must revise both the estimated useful life and the estimated resale price. Treas. Reg. § 1.167(a)–1(b), (c). This explicit provision applies here. Petitioner sold the *Feuer* in December 1957. When at the end of 1957 petitioner computed its depreciation for that year, it knew that it had used the *Feuer* for a "significant[ly]" shorter period than originally estimated, *i.e.*, two years instead of three. It was thus required to compute its depreciation for 1957 in light of the "conditions known to exist at the end of" that year. Since it had sold the *Feuer* for more than its original purchase price, it was entitled to no depreciation for 1957.

Moreover, even if a substantial change in useful life had not triggered a revision of petitioner's depreciation formula, the general rules that depreciation deductions must be reasonable in light of the conditions known to exist at the end of the tax year in question and that total depreciation may never knowingly exceed net cost would have prevented petitioner from taking any depreciation deduction in 1957. The Regulations state only one exception to this general rule and it has no application here.

This Court also has repeatedly recognized that depreciation is an eminently realistic and practical concept designed to permit periodic deductions which total as nearly as possible the actual net cost of an

asset. The principles enunciated in prior decisions demonstrate that petitioner cannot continue to use an "artificial" or "false assumption" as to the *Feuer's* net cost, however reasonable that estimate may have been when made. Petitioner may not "knowing[ly] distort" income by depreciating an asset below "what reasonably appears to be the price that will be received when the asset is retired." Once the conditions changed petitioner was required (absent the applicability of the one exception in the Regulations) to "adjust" its estimates to reflect "the real sale price and the actual duration of use." Only by the use of "correct" figures can the total depreciation deductions be kept as close as possible to an asset's "actual cost." *Massey Motors, Inc.* v. *United States*, 364 U.S. 92, 101, 105; *Hertz Corp.* v. *United States*, 364 U.S. 122, 127.

II

Petitioner's reliance upon "business accounting principles" is misplaced. As this Court has held, commercial accounting practices are not controlling where, as here, they fail clearly to reflect income for tax purposes. Accountants who prepare income statements for investors have a purpose far removed from that of the taxing authorities. The accountants' main interest is to avoid overstating current income from operations, even if this requires an offsetting book entry to a special non-recurring income account. The tax authorities' aim is to give the taxpayer periodic deductions which equal but do not exceed the taxpayer's actual net cost of the asset. The difference in purpose dictates a difference in result.

III

Nor is there merit to petitioner's contention that all increases in an asset's value due to market appreciation are entitled to capital gain treatment, and that such increases may not, therefore, be used to reduce losses in value due to wear and tear. Section 1231 of the Code provides only that if there is any gain on the sale of a depreciable asset, it is, in general, taxed as capital gain. Nothing in the language or legislative history of that section indicates any Congressional intent to affect in any manner the orderly judicial elaboration of the statutory phrase "a reasonable allowance for" "depreciation" or to withdraw the express power to issue "regulations" governing the manner in which the "allowance [for depreciation shall be] computed." 1954 Code § 167.

Moreover, the basic structure of the scheme of depreciation rebuts petitioner's contention that Congress intended taxpayers to get capital gain on all increases in an asset's value due to market appreciation. The first step a taxpayer takes in computing depreciation is to deduct the asset's estimated resale value at the end of its period of use in his business. If the value of such used assets can be expected to increase during this period, he must therefore use the higher expected price. And if at any time thereafter the asset's expected useful life changes significantly, the taxpayer must re-estimate the asset's resale price. Thus any increase in value that can be foreseen either at the time the asset is first acquired or at the time its useful life is recomputed are frozen into the non-depreciable basis of the asset.

The enactment of Code Sections 1245 and 1250 in 1962 and 1964 does not impair the Commissioner's position here. Like Section 1231, they relate to the method of taxing gain, if any, on disposition of depreciable assets, requiring it to be taxed as ordinary income in certain carefully prescribed circumstances. The Committee Reports state that Congress was aware of cases like the instant one and that they did "not intend to affect" them. H. Rep. No. 749, 88th Cong., 1st Sess., p. 103; S. Rep. No. 830, 88th Cong., 2d Sess., p. 133.

IV

Petitioner erroneously claims that there was a long-settled administrative practice opposed to the Commissioner's present position. Before 1942 the Commissioner had no considered and consistent administrative practice. During much of this period the question had no bearing upon tax liability since the gain from sale of depreciable assets constituted ordinary income. To the extent that any practice has developed in the years since 1942, it lends support to the Commissioner's case.

ARGUMENT

I

AT THE END OF 1957 PETITIONER KNEW THAT IT HAD SOLD THE "FEUER" FOR MORE THAN ITS ORIGINAL COST AND THAT ITS USE OF THE SHIP HAD THUS COST NOTHING; HENCE IT WAS NOT ENTITLED TO ANY DEPRECIATION DEDUCTION FOR THAT YEAR

In December 1955, petitioner purchased the *S.S. Feuer* for $469,000. In light of the circumstances

and conditions existing at the time of purchase, petitioner estimated that the vessel would be useful in its business for three years, at which time it would have a resale or salvage value of approximately $54,000. The Commissioner acknowledges that these estimates were reasonable when made. Using the "straight-line" method of depreciation,[2] petitioner took deductions on its 1955 and 1956 tax returns totaling $142,372. Thus at the beginning of 1957 (the tax year here in question), petitioner's undepreciated cost basis in the *Feuer* was $326,628 (*i.e.,* $469,000 original cost less $142,372 depreciation). In late 1957, petitioner sold the vessel for $695,500, which is more than $200,000 in excess of its original purchase price and more than $350,000 in excess of its undepreciated cost. The issue presented is whether petitioner is entitled to an additional depreciation deduction of $135,000 for the calendar year 1957, despite the fact that at the end of 1957 petitioner knew that its use of the ship during 1957 had cost it nothing.[3]

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[2] Under the straight-line method the cost of the property less its estimated salvage value is deductible in equal annual amounts over its estimated useful life. Treas. Reg. § 1.167(b)-1.

[3] The *Feuer* was sold for more than its adjusted cost basis at the beginning of 1957, so that under the Commissioner's position no depreciation is allowable for 1957. If, however, an asset is sold for less than its adjusted cost basis at the beginning of the year of sale, only that portion of the otherwise allowable depreciation deduction that would reduce the adjusted basis below the selling price would be disallowed. Rev. Rul. 62-92, 1962-1 Cum. Bull. 29. For example, if petitioner had purchased a ship for $400,000 with an estimated useful life of 3 years and an estimated salvage value of $100,000, it would have been entitled to a straight-line depreciation deduction of

If petitioner is allowed to deduct additional depreciation in 1957, its gain on the sale of the ship will be increased by exactly the amount of the depreciation deduction. Internal Revenue Code of 1954, §§ 1001, 1011, 1012, 1016(a)(2). The depreciation, however, would be an offset against ordinary income while the corresponding increase in gain on sale would generally be capital gain. See Code § 1231. Moreover, in the instant case the result is even more startling than the usual transformation of ordinary income into capital gain. Since petitioner elected a tax-free 12-month liquidation under Section 337 of the Code, its gain from the sale of the *Feuer* was not taxed at all. Thus if petitioner is permitted additional depreciation in 1957, its ordinary income will be reduced by approximately $135,000 without even a corresponding increase in taxable capital gain.

A. DEPRECIATION IS INTENDED TO GIVE A TAXPAYER PERIODIC DEDUCTIONS WHICH SHOULD TOTAL, AS NEARLY AS POSSIBLE, THE ACTUAL NET COST HE HAS INCURRED

The Internal Revenue Code is, in general, designed to permit a business to take deductions for the costs of generating taxable income. A taxpayer's out-of-pocket expenditures for a machine or a ship used in his trade or business are just as much an expense of earning income as are wages or rentals. There are, however, two differences: First, the machine or ship contributes to revenues in more than one tax period,

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$100,000 per year. If petitioner had then sold the ship for $375,000 after a half year of use, it would, under the Commissioner's view, be entitled to a $25,000 depreciation deduction.

and thus its net cost must be allocated or apportioned between various tax years. Second, the taxpayer does not know, at the time of purchasing the machine or ship, how much the use of the asset will ultimately cost him. Only after the asset has been resold (whether as scrap or as a used operable machine or ship) can its actual net cost to the taxpayer be ascertained with certainty.

Fairness, however, requires that the taxpayer be entitled to periodic deductions in the tax periods when the machine or ship is contributing to income.[4] Thus certain estimates are employed. In light of all the circumstances at the time of acquisition, the taxpayer estimates the period during which he will use the asset in his business (useful life) and the resale value it will have at the end of that period (salvage value). The taxpayer then takes deductions on his income tax returns for a portion of the estimated net cost of the asset (original cost less salvage value) over the period of the estimated useful life. Treas. Reg. § 1.167(a)-1.

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[4] The alternative, of course, would be to deny the taxpayer any depreciation deductions until he sold the asset, at which time he would know exactly how much its use had cost him. Then he could either deduct the entire net cost in the year of sale or deduct a portion of the actual net cost in each of the years of actual use. The former solution would result in a bunching of deductions attributible to a number of years. The latter would require taxpayers to amend perhaps a dozen years' returns every time they sell an asset and is (even aside from the problem of the statute of limitations) too wasteful and complicated a solution. See, *e.g.*, *Burnet* v. *Sanford & Brooks Co.*, 282 U.S. 359, 365; *Security Mills* v. *Commissioner*, 321 U.S. 281; *Virginian Hotel Corp.* v. *Helvering*, 319 U.S. 523, 526 ("Congress has elected to make the year the unit of taxation.").

If the circumstances existing at the end of any taxable year indicate that the taxpayer's original estimates were materially incorrect, it would make sense, in light of Congress' provision for "a *reasonable* allowance" for depreciation (Code § 167, emphasis added), to revise the depreciation formula for that year and for future years.[5] The Regulations do in fact explicitly provide that the "reasonableness of any claim for depreciation shall be determined upon the basis of conditions known to exist at the end of the period for which the return is made." The Regulations also state a specific example of such an adjustment: A taxpayer is required to revise both the estimated useful life and the estimated resale price whenever the "conditions known to exist at the end of the taxable year" indicate that the period during which the asset will be used in the taxpayer's business is significantly different than estimated. Treas. Reg.

[5] Because of the well-established principle that income taxes are computed on the basis of the facts existing at the end of the tax year, depreciation deductions for previous years (which were "reasonable" in amount at the time taken) would not be recomputed. See, *e.g.*, *Commissioner* v. *Mutual Fertilizer Co.*, 159 F. 2d 470 (C.A. 5); S. Rep. No. 665, 72d Cong., 1st Sess., p. 29 (1939–1 Cum. Bull. (Part 2) 496, 517); cases cited *supra*, fn. 4. Thus, there is no merit to petitioner's contention that it would be inconsistent to change the depreciation formula only prospectively without also revising depreciation deducted in all past years. Similarly, the changes in the proposed Regulations under the 1954 Code (see American Automotive Br., pp. 26–27, fn. 15, and Appendix B) were designed simply to make it clear that a salvage value estimate accepted as reasonable in a pre-sale year would not be revised "retroactively" to conform with actual salvage value and thus require a "recalculation" of depreciation allowed in pre-sale years.

§§ 1.167(a)–1 (b), (c), 1.167(b)–0. Depreciation for that year and subsequent years shall thereafter be computed in light of the revised estimates.

However, the Regulations state one exception to this general rule: When there is no substantial change in useful life, the depreciation formula will not be revised annually "merely because * * * changes in price levels" have affected the estimated resale price of the assets. Treas. Reg. § 1.167(a)–1(c). This exception makes good practical sense; if it were necessary to adjust the depreciation formula each time price levels rose or fell, a taxpayer would be required to appraise each of his depreciable assets annually. Since such re-estimated salvage values would "at best [still be] * * * merely informed estimates" subject to additional future fluctuations, this regulation was promulgated "to eliminate needless and endless [re-evaluations and] controversies." Rev. Rul. 62–92, 1962–1 Cum. Bull. 29, Appendix, *infra*, pp. 53–54. See also *Cohn* v. *United States*, 259 F. 2d 371, 378 (C.A. 6).

In short, depreciation deductions are designed to give a taxpayer current deductions the total of which will be as nearly equal as possible to the assets' actual net cost. In order to reach this goal the taxpayer's initial estimates of resale price and useful life must be "reasonable" in light of all the facts and circumstances at the time the asset was purchased; and if at the end of any succeeding tax year the estimates become unreasonable, they must be modified (except that when useful life is not being adjusted the esti-

mate of salvage value will not be changed merely because of changes in price levels).

B. THE REGULATIONS PROHIBIT PETITIONER FROM KNOWINGLY TAKING MORE DEPRECIATION DEDUCTIONS THAN THE "FEUER" HAD ACTUALLY COST IT

Applying these clear and fundamental principles to the instant case, we submit that petitioner is not entitled to any depreciation deduction for 1957 (the year in which it sold the *Feuer*) for two independently sufficient reasons:

First, the Regulations require a taxpayer to revise his depreciation formula whenever, in light of "conditions known to exist at the end of the taxable year," "there is a clear and convincing basis" for determining that the taxpayer will use the asset for a "significant[ly]" different period of time than had been estimated. Treas. Reg. § 1.167(a)-1(b); see also Treas. Reg. § 1.167(b)-0. Eight days before the end of its 1957 tax year petitioner sold the *Feuer*. Thus at the end of its 1957 tax year, petitioner had the clearest and most convincing possible evidence that the *Feuer* would not be used in its business for three years, as originally estimated, but that in fact the period of use would be only two years, *i.e.*, one-third shorter.

While the Regulations refer to a revision of the "*estimated* remaining useful life" (Treas. Reg. § 1.167 (a)-1(b), emphasis added), we believe that both the language of the Regulations and the principles on which they are bottomed cover the situation where (as here) at the end of the taxable year the taxpayer

knows the asset's actual useful life, and thus need not estimate anything. A taxpayer is certainly not excused from adjusting an asset's useful life because the circumstances indicating the need for the change are *too* clear, *i.e.,* they support not merely a more accurate estimate but a determination of the actual period of use in the business. The whole purpose of estimating useful life is to get the most accurate approximation possible of the period the taxpayer will use the asset. When the actual period of use is finally known, there is no longer any need to use estimates in computing further depreciation.

Thus at the end of 1957 when petitioner computed its depreciation for that year it knew that the original three-year estimate of the ship's useful life was "significant[ly]" wrong. Consequently, the Regulations required petitioner to revise both the useful life and resale price in light of the information available at the end of 1957.[6]

Second, we believe that petitioner would not be entitled to any depreciation deductions for 1957 even if its sale of the *Feuer* in December 1957 was not a

[6] If (instead of selling the *Feuer* in 1957) petitioner at the end of 1957 had a "clear and convincing basis" for believing that it would sell the *Feuer* in January 1958 for more than its original cost, the Regulations would plainly have required petitioner to revise its estimated useful life and salvage value, thus preventing it from taking any 1957 depreciation. That petitioner's sale took place in December 1957 rather than January 1958 cannot, we submit, produce the result petitioner seeks. Moreover, this demonstrates that amicus is plainly wrong in arguing that if the contract of sale had postponed delivery of the *Feuer* until January 1958 petitioner would have avoided disallowance of its 1957 depreciation (American Automotive br., p. 44).

sufficiently "significant" change in useful life to trigger a redetermination of salvage value. Petitioner's sale of the *Feuer* during 1957 at a price in excess of its depreciated cost at the beginning of the year is sufficient, we submit, to require disallowance of any further depreciation during 1957. The sole purpose of depreciation is to permit the taxpayer to deduct the net or out-of-pocket cost of an asset to him. In an effort to make the total deductions based on the estimates of salvage value and useful life as close to actual net cost as possible, the Regulations have long contained two basic statements of principle (Treas. Reg. § 1.167(b)-0):

1. "Regardless of the method used in computing depreciation, deductions for depreciation shall not exceed such amounts as may be necessary to recover the unrecovered cost or other basis less salvage during the remaining useful life of the property."[7] See also Treas. Reg. § 1.167(a)-1(a), (c).

2. "The reasonableness of any claim for depreciation shall be determined upon the basis of conditions known to exist at the end of the period for which the return is made."

These bedrock principles are the foundation for the specific regulation requiring a taxpayer to revise his estimate of useful life if at the end of any tax year his original estimate appears significantly inaccurate.

[7] American Automotive's brief misreads both this Regulation and Treasury Regulation § 1.167(a)-1(a) as barring depreciation below a reasonably "estimated" salvage value. (Br., pp. 24, 12, fn. 4.) Significantly American Automotive proposed so amending the draft regulations (American Br., Appendix B, p. 13a), but its suggestion was not adopted.

While the Regulations do not explicitly so provide, we believe that the basic purpose of the deduction for depreciation and the two statements of principle just quoted would (absent an explicit exemption in the Regulations) require a taxpayer to revise the estimated resale price of an asset any time changed circumstances at the end of a year indicated a resale value significantly different from the original estimate.

However, for the reasons discussed *supra,* p. 14, the Regulations provide that salvage value shall not be revised *"merely because of changes in price levels"* unless the depreciation formula is being re-examined anyway because of a change in useful life. We believe it quite clear that this salutary and eminently practical regulation was not designed to exempt from the usual rule a taxpayer who, like petitioner here, actually sold the asset for more than its undepreciated cost. Such a taxpayer would neither fall within the language of the regulation nor within its purpose. A sale which finally and irrevocably establishes the actual net cost of an asset is far more than a mere change in price levels. The Commissioner's reading of this regulation would not require a taxpayer to revalue his depreciable assets annually; only assets which have been sold would be affected, and they need not be valued since the actual resale price is known. Revision of the salvage value in such circumstances would not merely substitute one rough estimate for another, but would supplant an

estimate of the resale price with the actual and established resale price.[8] See Rev. Rul. 62-92, 1962-1 Cum. Bull. 29; *Cohn* v. *United States,* 259 F. 2d 371, 378 (C.A. 6); and the lower court's opinion in the instant case, 335 F. 2d 15, 18 (C.A. 2).

At the end of 1957, petitioner knew that although it had already (*i.e.,* in 1955 and 1956) deducted $140,000 depreciation, its use of the *Feuer* had cost it nothing. Yet petitioner here argues that it is entitled to additional depreciation in 1957. Petitioner pins this contention on the argument that once it has selected an estimated salvage value which was reasonable at the time chosen (*i.e.,* in 1955), it is not required to change that salvage value. Petitioner completely ignores both the basic principle that depreciation is intended to give the taxpayer deductions which are, in total, as nearly equal to the actual net cost of the asset being depreciated as possible and the explicit prohibition in the Regulations against ever knowingly taking more depreciation deductions than the net cost of the asset being depreciated. Instead petitioner takes a completely artificial and unrealistic view of depreciation.

[8] Nor could petitioner have avoided this result by merely postponing delivery until January 1958. Once it is clearly established by something more than a "mere * * * change in price levels" (*e.g.,* by a contract to sell) that the resale price of an asset is significantly different than estimated, the actual resale price must be used in computing depreciation. See *Smith Leasing Co.* v. *Commissioner,* 43 T.C. 37.

C. THIS COURT'S RECENT DECISIONS CONFIRM THE PROPOSITION THAT DEPRECIATION DEDUCTIONS CANNOT KNOWINGLY BE BASED ON AN "ARTIFICIAL" OR "FALSE ASSUMPTION" AS TO THE "ACTUAL COST OF EMPLOYING THE ASSET"

This Court's recent decisions make it clear that the computation of depreciation is to be done in an eminently reasonable and practical manner in order to reach a common sense result. In both ***Massey Motors, Inc.*** v. ***United States*** and ***Commissioner*** v. ***Evans,*** 364 U.S. 92, the taxpayers had purchased automobiles which they intended from the outset to resell substantially before the end of their physical lives. The taxpayers nevertheless argued (1) that in estimating salvage value they should use the automobiles' expected junk values at the end of their physical lives, and (2) that the estimated net cost so computed should be written off over the assets' estimated physical useful lives. The Commissioner, on the other hand, contended (1) that the taxpayers should realistically compute estimated net cost by using the estimated resale prices the cars would have (as used cars rather than as junk) at the time when the taxpayers actually expected to sell them, and (2) that this estimated net cost should be depreciated over the period the taxpayers actually expected to use the automobiles.

The Court accepted the Commissioner's position. It noted that since the purpose of depreciation is to allocate the "*actual* cost of employing the asset" "to the periods to which it contributes," the total depreciation deductions should equal "only the [original] cost of the asset less the estimated salvage, resale or second-hand value." 364 U.S. at 104, 105, 107 (em-

phasis added). And it emphasized that in estimating "the actual cost of employing the asset," the taxpayer should attempt to come as close as possible to *"the real salvage price and the actual duration of use"*; thus whenever "a mistake has been discovered," an "adjustment" must be made in the salvage value or the useful life. 364 U.S. at 105 (emphasis added).

The Court rejected the taxpayers' unrealistic computations as based on a "false assumption" and said that "correct tabulations, not artificial ones, [must] be used" in computing depreciation whenever possible. 364 U.S. at 105, 101. The Court noted that by use of these "false" and "artificial" assumptions, the taxpayers were deducting more depreciation than the "actual cost" of the asset, thus "convert[ing] the inflated amounts [of depreciation] from income taxable at ordinary rates to [gain on sale of the assets] * * * taxable at the substantially lower capital gains rates. This, we believe, was not in the design of Congress." "Congress intended by the depreciation allowance not to make taxpayers a profit thereby, but merely to protect them from a loss." 364 U.S. at 97, 101.

In *Hertz Corp.* v. *United States*, 364 U.S. 122, decided the same day as *Massey* and *Evans*, the Court considered a closely related question: whether a taxpayer using the declining balance method could depreciate an asset below its estimated resale value. The Court stated that there is an "overriding statutory requirement that the depreciation deduction be a *reasonable* allowance" (emphasis in original), and that permitting a taxpayer to depreciate an asset below salvage value "would permit a *knowing distortion*

of the expense of employing the asset in the years after that point is reached" (364 U.S. at 127, emphasis added). Thus, the Court refused to allow depreciation "beyond what reasonably appears to be the price that will be received when the asset is retired." *Ibid.*

While *Massey*, *Evans*, and *Hertz* did not deal with the exact question presented here, we believe that the principles upon which those decisions were based are particularly apposite here. In those cases, the Court recognized that the "fundamental concept of depreciation" is to give the taxpayer a deduction for the actual net cost of an asset, 364 U.S. at 128, and that estimates are used only because the resale price is not known. Thus in computing the depreciation deducted for each year, the taxpayer must use the most accurate possible estimates in light of all the circumstances known to exist at the year end; he cannot "knowing[ly] distort" income by depreciating the asset below "what reasonably appears to be the price that will be received when the asset is retired." The one exception is that he need not re-estimate salvage value "merely because of changes in price levels." With this single exception, he may not use "artificial" or "false assumption[s]" in order to "make * * * a profit" by transforming ordinary income into capital gain (or, as here, into nontaxable gain). When the asset has been sold the taxpayer, instead of knowingly using a "false assumption," must em-

ploy the "real salvage price."[8] To permit petitioner to take a depreciation deduction for 1957 would, as the court below observed, give it "an allowance [it] * * * knows to be fictional at the time [it] * * * claims it" (R. 81).

D. A TAXPAYER WHO KNOWS THAT HIS USE OF AN ASSET IS COSTING HIM NOTHING IS NOT ENTITLED TO A DEPRECIATION DEDUCTION

There is nothing unusual or startling about the result we seek, *i.e.*, that although petitioner used the *Feuer* for all but eight days of 1957, it will not receive any depreciation deduction for that year. In general, the Internal Revenue Code taxes net monetary income. A taxpayer is not entitled to a deduction (depreciation or otherwise) if he need not and does not

[8] The Court's opinion in *United States* v. *Ludey*, 274 U.S. 295, cited and relied upon by petitioner, is consistent with these basic principles. Because of the structure of the tax laws in 1917, the issue presented here did not exist in *Ludey*. See, *infra*, fn. 23. However, the Court's language clearly implied that total depreciation plus salvage value should, as nearly as possible, "equal" the asset's "original cost." It certainly lent no support to petitioner's contention that additional depreciation deductions should be permitted after the taxpayer knows that "the aggregate of the sums [already deducted plus] * * * the salvage value * * * equal * * * the original cost." 274 U.S. at 300-301.

In *Detroit Edison Co.* v. *Commissioner*, 319 U.S. 98, 102, the Court said "that the taxpayer's outlay is the measure of his recoupment through depreciation accruals." And, in *Virginian Hotel Corp.* v. *Helvering*, 319 U.S. 523, 528, the Court stated that a taxpayer who had already taken depreciation deductions cannot take a "second deduction" for the same depreciation. While again the issue was not presented there, we believe that these cases also reflect the philosophy that a taxpayer cannot intentionally deduct more depreciation than the known actual net cost of the asset.

pay out any money. Thus if an employer receives $10,000 worth of services from an employee, but because of a favorable employment contract the employer is obliged to pay only $1,000 in salary, he is entitled to only a $1,000 tax deduction.

Similarly, if because of unusual market conditions a taxpayer pays $1,000 for an asset that normally would cost him $10,000, he is entitled to only $1,000 of depreciation regardless of how long he uses the asset. Moreover, if he reasonably expects to use the asset for 10 years and then to resell it for $1,000, he is not entitled to any depreciation even though the asset declines in value $9,000 because of wear and tear. See, *e.g.*, *Massey Motors* v. *United States,* 364 U.S. 92.

At the end of 1957, petitioner knew that its use of the *Feuer* for two years had cost it nothing. It was thus entitled to no depreciation deduction for 1957. The fact that petitioner had received reasonable but, as it turned out, completely unwarranted depreciation deductions in previous years (1955 and 1956) scarcely furnishes a reason for granting it an additional excessive deduction in the year of sale (1957) when it *knew* that it had incurred no monetary cost for using the *Feuer*. See, *e.g.*, *Hertz Corp.* v. *United States,* 364 U.S. 122, where this Court denied the taxpayer any depreciation deduction for those years after it had depreciated its cost basis in the assets down to their expected resale price.[10]

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[10] Petitioner cites the Regulation providing that "The period for depreciation of an asset shall begin when the asset is placed in service and shall end when the asset is retired from service." Treas. Reg. § 1.167(a)-10(b). Of course, in the vast number of

II

PETITIONER'S RELIANCE ON COMMERICAL ACCOUNTING PRACTICE IS WITHOUT MERIT

Petitioner's reliance on "business accounting principles" (Pet. Br. 12–18, American Automotive Br. 37–40, S & A Co. Br. 13–18) is plainly misplaced. This Court has repeatedly held that generally accepted commercial accounting practices are not controlling when they fail clearly to reflect income for tax purposes. ***American Automobile Assn.*** **v.** ***United States,*** 367 U.S. 687, 692–694; ***Commissioner*** v. ***Hansen,*** 360 U.S. 446; ***Bazley*** v. ***Commissioner,*** 331 U.S. 737, 741; ***Brown*** v. ***Helvering,*** 291 U.S. 193, 202–203.[11]

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cases where an asset is scrapped or sold without a gain, a taxpayer is entitled to take depreciation deductions up to the date of sale. That Regulation does not, however, state that a depreciation deduction shall in all cases be allowed up to the date an asset is retired from service. It merely reiterates the general rule that "*The period for depreciation* * * * shall end when the asset is retired" (emphasis added). Of course, whether depreciation deductions are allowable for the full period of use depends on the facts in the particular case and the other provisions of the Regulations relating to the computation of depreciation deductions. See, *e.g.*, Treas. Reg. § 1.167(b)-0. Certainly even petitioner would not contend that a taxpayer who continues to use an asset after he has already depreciated all of its original cost would be entitled to additional depreciation deductions during "the period [until it] * * * is retired from service." See, *e.g.*, *Hertz Corp.* v. *United States*, 364 U.S. 122.

[11] The cases cited by petitioner are not to the contrary. In *Stratton's Independence, Ltd.* v. *Howbert*, 231 U.S. 399, 423, the Court expressly refused to consider whether depreciation as "charged in practical bookkeeping" had any bearing on tax liability. In *Von Baumbach* v. *Sargent Land Co.*, 242 U.S. 503, 524, the Court reached only the conclusion that Congress had,

The difference between the accountants' and the taxing authorities' treatment of year of sale depreciation stems from a divergence in the purpose each seeks to accomplish. For tax purposes a taxpayer is entitled to periodic deductions equal in amount to the net cost of the asset. If, because of the necessary use of estimates, the taxpayer takes these deductions too quickly, he is not entitled to any more. For example, if a taxpayer reasonably estimates that a machine he purchased for $10,000 in 1931 will be retired in 1941 with negligible scrap value, he would deduct $1,000 annually. If, however, because of the Second World War the taxpayer continued to use the fully depreciated machine until 1945, he would be entitled to no further depreciation during the last years of use. See, *e.g.*, *Hertz Corp.* v. *United States*, 364 U.S. 122.

On the other hand, accountants who are preparing financial statements for stockholders have a much different purpose in mind. Their main interest is in avoiding any overstatement of current net income from operations—a matter crucial to investors in evaluating securities. The accountant is thus not necessarily concerned that the total depreciation de-

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in general, meant the same thing by "depreciation" as business men understood it to be and that this did not include depletion of mineral deposits. It did not hold that every detail of tax depreciation was controlled by accounting principles. And in *Real Estate Title Co.* v. *United States*, 309 U.S. 13, 16, the Court said that "obsolescence" in the tax statute connotes functional depreciation "as it does in accounting and engineering terminology". It did not say that it was so *because* accounting or engineering terminology controlled tax liability.

ductions (including those in the year of sale) have exceeded an asset's actual net cost, so long as net operating income for the current year is not exaggerated. The accountant can balance the books by crediting the excessive year-of-sale depreciation to a special non-recurring income account.

Since the reasons for the accountants' policy of excessive year-of-sale depreciation differ radically from the income tax purpose of depreciation deductions, they are hardly controlling upon the taxing authorities. We note, indeed, that even the accounting works on which petitioner relies recognize that accounting for business purposes and accounting for tax purposes may be, and usually are, two different things. See, *e.g.*, I Dewing, *Financial Policy of Corporations* (5th ed.), p. 540, fn. h: "it should be observed at the outset of any discussion of depreciation that the connotations of the term itself and the implications are used differently by accountants and by the income tax auditors—state as well as federal." See also, *id.*, pp. 540–541, fn. i, and p. 542, fn. i. Dewing states further that "In all this voluminous literature pertaining to depreciation found in accounting, legal and business periodicals, there is surprisingly little unanimity of opinion," and that "The law governing the practical application of the principle of depreciation to corporate accounts is as confused as are the principles tolerated by business executives and accountants in their actual practices." *Id.*, pp. 539–540, fn. g, and p. 541, fn. i.

III

NO OTHER PROVISION IN THE CODE CONFLICTS WITH THE COMMISSIONER'S INTERPRETATION OF SECTION 167

A. SECTION 1231 DEALS ONLY WITH HOW GAIN, IF ANY, ON THE SALE OF A DEPRECIABLE ASSET SHALL BE TAXED

Petitioner argues that although its use of the *Feuer* cost it nothing, it is nevertheless entitled to a $135,000 depreciation deduction in 1957 because the decline in an asset's value due to wear and tear in the year of sale should not be offset against the increase in its value due to market appreciation. According to this argument, any increase in the value of a depreciable asset between the time of its purchase and the date of its sale should be taxed as capital gain. A taxpayer would be deprived of a part of this capital gain treatment if he were prohibited from depreciating the asset in the year it was sold at a profit.[12] (Of course, since petitioner sold the *Feuer* as part of a 12-month liquidation under Section 337 of the Code, the resulting increased profit on sale would not even be subject to the capital gains tax.)

We submit two answers to this argument.[13]

[12] Petitioner and American Automotive apparently are not in agreement regarding the scope of this theory. Petitioner's brief indicates that it might be proper to disallow year-of-sale depreciation if the asset is "sold at or near the end" of its originally estimated useful life. (Pet. Br. 50.) American, on the other hand, would apply the theory to require the allowance of year-of-sale depreciation regardless of when the property is sold. (American Br. 11–12, 49.)

[13] The same argument, we note parenthetically, was presented at length by all three taxpayers in the *Massey*, *Evans* and *Hertz* cases (see brief for the petitioner in *Massey Motors*, No. 141 at

First, the short answer is that in granting capital gain for profits on sales of depreciable assets Congress made no effort to prescribe any methods for computing depreciation. Section 1231 and its predecessor [14] merely state that profits, if any, resulting from the sale or exchange of certain types of property shall be taxed as capital gain. Nothing in the language or history of that provision indicates any Congressional intent to affect in any manner the orderly judicial elaboration of the phrase "a reasonable allowance for" "depreciation" in Section 167. Nor is there any evidence that Congress sought to withdraw the power it had expressly given the Secretary of the Treasury or his delegate to issue "regulations" governing the manner in which "an allowance [for depreciation shall be] computed" (Code § 167(b)), pursuant to which the Regulations discussed *supra* were promulgated.

The Commissioner and petitioner agree that Section 1231 requires any gain recognized on the sale of the *Feuer* to be taxed as capital gain (in fact, because of Code § 337 no gain was recognized). However, the sole question presented by this case is whether petitioner is entitled to $135,000 of depreciation in 1957

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the October Term, 1959, pp. 32–33; brief for the respondent in *Evans*, No. 143 at the October Term, 1959, pp. 71–83; and brief for the petitioner in *Hertz*, No. 283 at the October Term, 1959, pp. 69–80), and plainly not accepted by the Court. In fact, the court of appeals in *Evans* v. *Commissioner*, 264 F. 2d 502, 513–514 (C.A. 9), relied on this argument in holding against the Commissioner. This Court reversed that decision, *sub nom. Massey Motors, Inc.* v. *Commissioner*, 364 U.S. 92.

[14] Int. Rev. Code of 1939, § 117 (j), added by Rev. Act of 1942, § 151(b), 56 Stat. 846, 26 U.S.C. (1952 ed.) § 117(j).

(the year of sale) which, of course, would increase its unrecognized gain on sale by that amount. Seeking aid in Section 1231 merely begs that question.

Second, petitioner's argument is anchored to the premise that Congress intended taxpayers to get capital gain treatment for all increases in an asset's value due to market appreciation. Based on this premise it is argued that depreciation deductions should never be reduced because of increases in an asset's value after its purchase, because that would prevent the taxpayer from receiving capital gain treatment on the full appreciation. We challenge the premise.

It is not at all unusual for the allowance for depreciation to be reduced because of expected or actual increases in market values after the date of purchase. The first step a taxpayer must take in ascertaining the portion of his purchase price that can be depreciated is to deduct the estimated resale value of the asset at the end of its useful life. If, for example, the taxpayer purchases a ship for $500,000 and expects to use it for three years and then resell it, he must make the best possible estimate of its resale value at the end of that period. If because of a current oversupply of such ships, used vessels of that nature were, at the time of the taxpayer's purchase, selling for only $100,000, but it was reasonably foreseeable that the market would firm up within three years (perhaps to $200,000), the taxpayer must estimate a salvage value equal to the higher resale price expected in three years. In such a case he must use the latter figure in computing depreciation. There-

fore, to the extent that a rise in the second-hand value of the asset between the time of its purchase and the time of its expected sale can be foreseen, the taxpayer is prohibited from taking depreciation and prevented from getting capital gain on this increase in market value. This, of course, pierces the core of petitioner's claim as to the significance of Section 1231 in computing depreciation.

Moreover, other aspects of the computation of depreciation refute petitioner's argument even more forcefully. Focusing again on the taxpayer in the above example (who purchased a ship for $500,000 with the intention to use it for 3 years at which time he expected to resell it for $200,000), he would take $100,000 of depreciation the first year (500,000 less $200,000÷3). Assume that near the end of the taxpayer's second year of use an international crisis of apparently long duration (*e.g.*, the Korean conflict) developed and in light of these conditions the taxpayer then expected to use the ship for a total of 5 years (instead of three). Because of the taxpayers significant change in expected useful life he is required to adjust the depreciation formula for that year and for future years. As a part of this adjustment the taxpayer is required to re-estimate the ship's resale value "based upon facts known at the time of such redetermination of useful life." Treas. Reg. § 1.167(a)-1(b), (c). Therefore, if the second-hand value of such ships had increased during the two years that elapsed between taxpayer's purchase of the ship and his re-estimate, his depreciation deductions would be reduced solely because of the in-

crease in the ship's market value. For example, if, because of the crisis, the expected second-hand value of such ships had shot up from \$200,000 to \$400,000, the taxpayer would not be entitled to any further depreciation deductions during the last four years of use. And if, as anticipated, the taxpayer eventually sold the ship for \$400,000, he would have no gain or loss on the disposition.[15]

The basic structure of the scheme of depreciation deductions thus destroys the bald suggestion that Congress meant taxpayers to get capital gain on the full amount of an asset's appreciation in value, even if such a result required depreciation in excess of the asset's known or reasonably expected net cost.

B. NEW SECTIONS 1245 AND 1250 ALSO DEAL EXCLUSIVELY WITH THE TAXATION OF GAIN ON DISPOSITION OF AN ASSET, AND NOT WITH THE COMPUTATION OF DEPRECIATION DEDUCTIONS

Nor do the recently enacted Sections 1245 and 1250 of the Code impair the Commission's position here. Those sections (enacted in 1962 and 1964, respectively)[16] were aimed at prospectively altering the

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[15] Neither petitioner nor the *amici* suggest that the Regulations which require this result are invalid. In fact, their briefs indicate that they agree with the requirement that salvage value be revised whenever useful life is adjusted (see, *e.g.*, Pet. Br., pp. 14, 25; S & A Co. amicus br., p. 37; American amicus br., p. 19). Nor do we think petitioner could have attacked the Regulations. We believe that the statutory provision requiring the "allowance [for depreciation to be] computed in accordance with regulations prescribed by the Secretary [of the Treasury] or his delegate" is more than sufficient authorization for this regulation. Code § 167(b).

[16] Revenue Act of 1962, P.L. 87-834, 76 Stat. 960, § 13; Revenue Act of 1964, P.L. 88-272, 78 Stat. 19, § 231.

method of taxing gains, if any, on the disposition of depreciable assets. In general, they provide that in certain carefully defined circumstances a taxpayer's gain on the disposition of depreciable personal property (Section 1245) or depreciable real estate (Section 1250) shall be taxed as ordinary income. Sections 1245 and 1250 (as well as the earlier legislative proposals out of which they arose, see Pet. Br., pp. 34–38) are concerned with the manner in which gains shall be taxed, not with the computation of depreciation. In fact the committee reports explicitly recognize this fact:

> * * * the enactment of this provision is not intended to affect the question of whether all or any part of a claimed deduction for depreciation is in fact allowable. For example, since in the year real property is sold the actual value of the property is known, it has been held that depreciation deductions should not be allowed to the extent they reduce the adjusted basis of the property below the actual amount realized. *This provision*, in providing for ordinary income treatment for certain additional depreciation, *is not intended to affect this holding.* [H. Rep. No. 749, 88th Cong., 1st Sess., p. 103; S. Rep. No. 830, 88th Cong., 2d Sess., p. 133.] [17]

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[17] The President's statement to Congress makes it clear that these legislative proposals are directed toward "depreciation * * * deducted * * * by the seller in *previous* years." The President's 1961 Tax Recommendations (H. Doc. No. 140, 87th Cong., 1st Sess., p. 11, emphasis added).

In short, nothing in the language or history of Sections 1245 and 1250 lends any support to petitioner's argument that Congress understood Section 167 (the depreciation section) as authorizing a taxpayer to use a known-to-be-wrong estimated resale price in computing depreciation for the year an asset was sold.[18]

IV

THERE IS NO LONG-STANDING ADMINISTRATIVE PRACTICE CONTRARY TO THE COMMISSIONER'S POSITION

Petitioner argues that in "more than four decades of administrative practice and rulings" the Commissioner has permitted year-of-sale depreciation, and that this consistent position "has been elevated to a rule of law by repeated statutory reenactment." (Pet. Br., p. 18.) We disagree.

In support of its position petitioner cites four published rulings of the Internal Revenue Service, none of them later than 1927. Three of these four rulings dealt with tax years before Congress first enacted any provision for capital gain.[19] Before 1921, the gain on sale of a depreciable asset was taxed as

[18] The enactment of Sections 1245 and 1250 does not render the issue presented in the instant case unimportant. First, those sections apply only to depreciation taken after the date of their enactment (1962 for personal property and 1964 for real estate). And second, at least with regard to real estate, this Court's decision in the instant case will play a significant role even after the new sections are fully effective. If a taxpayer holds real property for at least 10 years, the sections will be inapplicable, and if he holds it between 20 months and 10 years, they will be only partially applicable, depending on the length of the holding period.

[19] There was no provision for capital gain until the Revenue Act of 1921, 42 Stat. 227, § 206(a).

ordinary income; therefore, it made no difference in tax liability whether year-of-sale depreciation was allowed on assets sold at a gain. If, for example, $1,000 of depreciation were disallowed in the year of sale, operating income would be increased by $1,000 and the gain on sale would be decreased by the same amount. Since both were taxable as ordinary income there would have been no tax effect. Thus in three of the four rulings cited by petitioner the issue with which we are here concerned, even if presented, would not have been considered, since it could have made no difference in the amount of tax to be collected.

In the fourth ruling cited the Bureau altogether failed to focus upon the issue presented here, *i.e.,* the allowability of a depreciation deduction in the year of a profitable sale of the asset. The facts stated do not enable the reader to ascertain whether the taxpayer actually had a gain on the sale of the asset.[20] Moreover, that ruling (which was merely a General Counsel's Memorandum) was concerned with the difficult problem of allocating depreciation deductions on real estate held in trust between the life tenant, the remainderman and the trustee. G.C.M. 1597, VI-1 Cum. Bull. 71 (1927). Patently, there was no focus upon the question presented here (even if there were a gain), and the offhand reference to de-

[20] While the ruling states that the real estate was sold "at an advance" over its appraised value at the testator's death, it does not indicate whether the taxpayer spent money on improvements or otherwise increased his basis in the property. In fact, the ruling states that the taxpayer had inquired about the method of determining whether there was a "gain or loss from * * * sale."

preciation up to the time the property was sold cannot possibly be treated as a considered determination.[21] Finally, as this Court has noted more than once, the front cover of the Cumulative Bulletins expressly states that such rulings, not having been "formally approved and promulgated by the Secretary of the Treasury," "have none of the force or effect of Treasury Decisions and do not commit the Department to any interpretation of the law." See *Dixon* v. *United States,* 381 U.S. 68, 73; *Helvering* v. *New York Trust Company,* 292 U.S. 455, 468.

Petitioner also relies on the position taken by the Commissioner in a number of cases, mostly before the Board of Tax Appeals in the 1920's. In many of these cases the Commissioner did permit depreciation up to the date of sale. However, virtually all of these cases arose within a few years after the advent of the income tax when the Commissioner and the courts were fully occupied with establishing the basic ground rules for computing depreciation and determining the amount of gain on sale. In none of those early cases

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[21] Nor did the three rulings which dealt with the pre-capital gain years discuss or consider this question. In fact in one of them it was clear from the facts stated that the taxpayer did not have a gain on the sale of the asset. I.T. 1494, I-2 Cum. Bull. 19 (1922). Another dealt in general terms with assets "abandoned or scrapped" on which a taxpayer would seldom be expected to recognize a gain. I.T. 1158, I-1 Cum. Bull. 173 (1922). Although the remaining one apparently concerned a profitable sale, it was merely a half-page statement of the conclusion reached by the Committee on Appeals and Review in a particular case dealing with both depletion and depreciation without stating the facts and without exhibiting any awareness of the issue presented here. A.R.R. 6930, III-1 Cum. Bull. 45 (1924).

was either the Commissioner's or the courts' attention focused on the issue presented here. Rather (with two minor exceptions, discussed *infra*, p. 38), all of the cases were concerned solely with other complicated issues of depreciation which held the Commissioner's and the courts' attention.

For example, a substantial number of the cases cited by petitioner involved the fundamental issue whether, in computing either depreciation or gain or loss on an asset acquired before 1913, the taxpayer must use the asset's cost or its value on March 1, 1913. Moreover, most of the cases also involved taxpayers who had deducted no depreciation at all; thus the question presented to the courts was whether, when these assets were sold, the taxpayers had to reduce their cost basis for the assets by the amount of depreciation they could have deducted. Many of the cases contained both this issue and the pre-1913 problem.[22] Thus, while most of the cited cases contain an offhand reference to depreciation from the date of acquisition to the time of sale, it is clear that neither the Commissioner nor the courts actually con-

[22] Other cases cited by petitioner involved such questions as whether a taxpayer should have deducted depreciation on an idle factory, whether another taxpayer could have deducted depreciation on unprofitable real estate, and whether a trustee who was previously not permitted to deduct depreciation on assets held in trust must nevertheless reduce his cost basis for those assets. Again these cases centered on the Commissioner's attempts to reduce the taxpayer's cost basis by the amount of depreciation he had never deducted. And again the Commissioner and the courts never addressed themselves to the period of depreciation as opposed to the allowability of depreciation on such assets in general.

sidered whether depreciation should be allowable in the year of a profitable sale. Instead, their full attention was directed elsewhere.[23]

In only two of the cases dealing with pre-1938 tax years was the deductibility of depreciation in the year of a profitable sale actually considered, and there only in a passing manner. Moreover, in those two cases the Commissioner with equal success took inconsistent positions, disallowing such depreciation in one case and allowing it in the other. Compare *Duncan-Homer Realty Co.* v. *Commissioner,* 6 B.T.A. 730, with *Herbert Simons* v. *Commissioner,* 19 B.T.A. 711.

In 1938 Congress withdrew depreciable assets from the scope of the capital gains provisions, and from then until 1942 the issue here presented was again (as in pre-1921 tax years) irrelevant to tax liability. In 1942 the predecessor to present Section 1231 was enacted,[24] so that taxpayers might again, under speci-

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[23] Both *United States* v. *Ludey*, 274 U.S. 295, and *Eldorado Coal & Mining Co.* v. *Mager*, 255 U.S. 522, cited and heavily relied upon by petitioner, were decided under the Revenue Act of 1917 (*i.e.*, before the advent of capital gain), and thus the issue presented here was neither presented nor considered. In fact, *Eldorado* was concerned with a constitutional problem and *Ludey* dealt with the basic question whether (in the absence of a statute so providing) an asset's cost basis had to be reduced by the amount of depreciation a taxpayer was entitled to deduct. Moreover, the only offhand reference to year-of-sale depreciation in either opinion is a statement that "*It is averred in the declaration* that, * * * subtracting depreciation and depletion to the date of sale, it appears that there was" a gain on sale. 255 U.S. 526 (emphasis added).

[24] Internal Revenue Code of 1939, § 117(j), added by Revenue Act of 1942, § 151(b), 56 Stat. 846, 26 U.S.C. (1952 ed.) § 117(j).

fied circumstances, receive capital gain treatment on profits from the sale of depreciable property. Shortly thereafter, the Commissioner, apparently for the first time, focused on the significance of the issue presented in the instant case. In two well known and hard-fought cases the Commissioner disallowed depreciation deducted in the tax years 1942 and 1944, *i.e.,* the year the change in law revitalized the issue and two years later.

In *Wier Long Leaf Lumber Co.* v. *Commissioner,* 9 T.C. 990,[25] the Commissioner challenged the deductibility of 1942 depreciation on a sawmill and three automobiles which the taxpayer had sold at a substantial gain during that year. The facts there were quite similar to the instant case; "by reason of war conditions existing throughout 1942, the price for which the mill and mill equipment could be sold was far in excess of the estimated salvage value" (9 T.C. at 992), while here the Suez crisis had the same effect. After noting that for some time before 1942 the issue had been academic, the court upheld the Commissioner's disallowance of year-of-sale depreciation with respect to the sawmill (9 T.C. at 998):

> In the present taxable year [*i.e.,* the year of sale] petitioner had all of the facts before it upon which it could compute an accurate amount to be deducted by it as its depreciation allowance for that year. In order to arrive at the correct amount [of depreciation], i.e., the

[25] The Tax Court's decision on an unrelated excess profits tax issue was affirmed in part and reversed in part, 173 F. 2d 549 (C.A. 5), but the depreciation issue was not mentioned.

> "reasonable allowance" under the statute, it had only to adjust the annual deduction which it proposed to take for the instant year by comparing its basis for the property with the total deductions previously taken and the current ascertained correct salvage value. * * * In this manner depreciation can be kept to an accurate provision for the return of petitioner's capital investment in the property. That is what the law contemplates. * * *

Thus with regard to the sawmill the Commissioner and the court took exactly the position we maintain here. However, without stating any persuasive distinction, the court held to the contrary with regard to the three automobiles.

Our inability to reconcile the Tax Court's two inconsistent holdings is not crucial. What is significant for purposes of this case is that almost immediately after the 1942 change in law the Commissioner focused on the problem and took the position we advocate here. Whether the Commissioner won the *Weir* case in part or in whole is, we believe, far less important.[26]

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[26] The Commissioner at first noted his acquiescence in the Tax Court's decision, 1948-1 Cum. Bull. 3, but later withdrew it and substituted his non-acquiescence, 1962-1 Cum. Bull 5. While it is not clear why the Commissioner initially acquiesced in the Tax Court's internally inconsistent holdings, his action does not constitute a binding precedent. The front of each cumulative bulletin clearly explains that rulings of this nature "have none of the force or effect of Treasury Decisions and do not commit the Department to any interpretation of the law." See, *e.g.*, *Higgins* v. *Commissioner*, 312 U.S. 212, 215-216; *Dixon* v. *United States*, 381 U.S. 68, 73; *Helvering* v. *New York Trust Co.*, 292 U.S. 455, 468.

In *Cohn* v. *United States,* 259 F. 2d 371 (C.A. 6), the first case to place the issue before a court of appeals, the government disallowed year-of-sale depreciation on assets sold at a gain in 1944 (two years after the change in law). In 1941 the taxpayers had formed flying schools to train military pilots. They reasonably estimated that the assets would be employed in their business until 1944 but erroneously used a zero salvage value. The district court held that in light of conditions known to exist in 1941 the taxpayers should have estimated the assets would be resold for at least 10 percent of cost. The court thus used a 10 percent salvage value in computing 1942 and 1943 depreciation. But the district court held that since the taxpayers sold the assets in 1944 for more than their depreciated cost at the beginning of the year, they were not entitled to any depreciation in 1944, the year of sale.

Neither the taxpayers nor the government disagreed with the district court's holding that 10 percent of cost constituted a reasonable estimate of salvage for computing 1942 and 1943 depreciation. The taxpayers, however, appealed from the district court's disallowance of all year-of-sale depreciation. The court of appeals affirmed and, in its opinion, stated the government's position as follows:

> the Government is not contending that salvage value should be adjusted annually in order to conform with current market values, or that it should be adjusted at all on account of "mere fluctuation in market value." [Rather the government seeks to adjust salvage value only] when it is shown by an actual sale of the asset that there is a substantial difference between

what was estimated and what it actually is. * * * Under such circumstances the practical difficulties urged upon us are largely nonexistent. [259 F. 2d 378.]"[27]

Thereafter, the Commissioner issued the first published ruling which dealt definitely with the issue. That ruling specifically stated that "the deduction for depreciation of an asset * * * in the year of disposition * * * is limited to the amount, if any, by which the adjusted basis of the property at the beginning of

[27] Petitioner cites an example in the Regulations relating to the sale of emergency facilities subject to Section 168's special 60-month amortization. In general, Section 168 permits a taxpayer who has obtained certification that a certain portion of his newly constructed facilities are "necessary in the interest of national defense during the emergency period" to write off the cost of these facilities, against income over a period of 60 months. In 1951 Congress enacted the predecessor to present Section 1238, providing that if a taxpayer should sell such emergency facilities any portion of the profit which was caused by Section 168's accelerated write-off shall be taxed as ordinary income. One of the examples in the Regulations issued under Section 1238's predecessor does in fact indicate that depreciation would be allowed in the year of a profitable sale. Treas. Reg. 111, § 29.117–9(a), added in 1951, republished as Treas. Reg. § 1.1238–1, example (1), to the 1954 Code. However, it is quite clear that the draftsman's attention was not focused on that issue, but rather on the complex interaction of Sections 168 and 1238. The Regulation has since been amended (retroactive to its original adoption in 1951) to reflect the Commissioner's position stated herein. T.D. 6825, 1965–26 I.R.B. 6. In any event, the existence of this obscure and unconsidered aspect of an example in a Regulation intended to illustrate another provision entirely, while the Commissioner was at the same time judicially attacking the deductibility of such depreciation, lends little support to petitioner's contention of "more than four decades of administrative practice and rulings." (Pet. Br., p. 18.)

such year exceeds the amount realized from sale or exchange." Rev. Rul. 62–92, 1962–1 Cum. Bull. 29, Appendix, *infra*, pp. 53, 54.

The next two cases to reach the courts of appeals were also decided in favor of the government. (The instant case, 335 F. 2d 15 (C.A. 2); and *United States* v. *Motorlease Corp.*, 334 F. 2d 617 (C.A. 2), now pending on petition, No. 24, this Term.) The Tax Court, which at first was in full agreement with the Commissioner, has more recently adopted a set of complicated tests which are exceedingly difficult to administer and require a complete examination of the detailed facts of each case. See, *e.g.*, *Macabe Co.* v. *Commissioner*, 42 T.C. 1105 (five dissents), on appeal to C.A. 9.[28] One court of appeals has now followed the Tax Court. *United States* v. *S & A Co.*, 338 F. 2d 629 (C.A. 8), pending on petition, No. 50, this Term. In brief, while the cases in the lower courts are in irreconcilable conflict, no court has refused to reach the merits on the ground that Congressional reenactments foreclose the issue.

[28] Contrary to petitioner's contention the Tax Court continues to disallow depreciation in the year of a profitable sale unless the taxpayer demonstrates that he qualifies under the complex rules laid down by that court, even when the reasonableness of the original estimates, when made, was not questioned. See, *e.g.*, *Miller* v. *Commissioner*, decided November 20, 1964 (P-H Memo T.C., par. 64,305); *Bell Lines, Inc.* v. *Commissioner*, 43 T.C. 358; and *The Covered Wagon, Inc.* v. *Commissioner*, decided April 5, 1965 (P-H Memo T.C., par. 65,079). In fact, in the *Macabe* case itself the Tax Court stated that it would adhere to the result it had previously reached in this case, *i.e.*, disallowance of petitioner's year of sale depreciation. 42 T.C. at 1110–1111.

Based on these facts, we submit that before 1942 there was no considered and consistent administrative practice and that to the extent any practice has developed in the years since 1942, it lends support to the Commissioner's position.

In addition, it is clear that there was no long-settled administrative practice of the kind that would be necessary to preclude the Commissioner's present position. As this Court said in *Higgins* v. *Commissioner,* 312 U.S. 212, 215-216:

> No regulation has ever been promulgated which interprets the [statutory phrase here in question] * * *, nor any rulings approved by the Secretary of the Treasury, i.e., Treasury Decisions. Certain rulings of less dignity, favorable to [the taxpayer] appeared in individual cases but they are not determinative. Even acquiescence in some Board [of Tax Appeals] rulings after defeat does not amount to settled administrative practice. *Unless the administrative practice is long continued and substantially uniform in the Bureau and without challenge by the Government in the Board and courts, it should not be assumed, from rulings of this class, that Congressional reenactment of the language which they construed was an adoption of their interpretation.* [Emphasis added.]

Similarly, in *Helvering* v. *Reynolds,* 313 U.S. 428, 430-431, the Court disregarded two contrary rulings published by the Bureau of Internal Revenue and at least two contrary court of appeals decisions:

> [These] office decisions of the Treasury, and * * * decisions of the lower federal courts * * * [did not] demonstrate that the earlier rule had become embedded in the law so that it could be changed not by administrative rules or regulations but by Congress alone. * * *

See also *Helvering* v. *New York Trust Co.,* 292 U.S. 455, 467–468; cf. *Dixon* v. *United States,* 381 U.S. 68.[29]

Moreover, in these cases the Court refused to apply the doctrine of Congressional reenactment on the basis of published ITs, GCMs, acquiescences and lower court decisions despite the fact that the Internal Revenue Service and the lower courts had focused upon the problem and reached a considered decision. In the instant case, on the other hand, neither the one GCM in which the issue may have been present nor the early lower court decisions cited by petitioner recognized or considered the issue; rather, the answer "was assumed without question and without an explicit holding on the point." *Jones* v. *Liberty Glass Co.,* 332 U.S. 524, 533, fn. 16.

In short, petitioner's elaborate attempt to make it appear that the Commissioner's position in Rev. Rul. 62–92 and this case runs counter to a long-established

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[29] Two earlier cases which relied upon lower level rulings not reviewed by the Secretary of the Treasury (*McFeely* v. *Commissioner*, 296 U.S. 102, and *Helvering* v. *Bliss*, 293 U.S. 144) were explicitly rejected in *Higgins* v. *Commissioner*, 312 U.S. at 216, fn. 10. See also *Helvering* v. *Reynolds*, 313 U.S. at 430–431.

and Congressionally recognized construction of the statute lacks any concrete foundation.[30]

CONCLUSION

When at the end of its 1957 taxable year petitioner sought to take a $135,000 depreciation deduction on its 1957 tax return, it knew that its use of the *Feuer* (which had already been resold) had cost it nothing. Its argument that it is nevertheless entitled to depreciation is bottomed on the use of an "artificial" and "false assumption" as to the ship's resale value, which at the end of 1957 it knew to be significantly inaccurate. Petitioner cannot "knowing[ly] distort" income and use the deduction for depreciation to intentionally "make * * * a profit." The explicit provisions in the Regulations prohibiting a taxpayer from depreciating an asset below salvage value, the holdings of this Court that depreciation is to be computed in a common sense and realistic manner, and Congress' purpose in enacting the depreciation statute that a taxpayer should be entitled to deduc-

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[30] As we have shown, in the only reference to this issue in any of the legislative history, two Congressional committees indicated that they did "not intend to affect" the holding of the lower courts "that depreciation deductions should not be allowed [in the year of sale] to the extent they reduce the adjusted basis of the property below the actual amount realized." See *supra*, p. 33.

In any event, even if petitioner were correct, this Court has often held that "prior administrative practice is always subject to change 'through exercise by the administrative agency of its continuing rulemaking power.'" *Commissioner* v. *P. G. Lake*, 356 U.S. 260, 266, fn. 5; see also, *e.g.*, *Automobile Club of Michigan* v. *Commissioner*, 353 U.S. 180, 183; *Manhattan General Equipment Co.* v. *Commissioner*, 297 U.S. 129, 134.

tions which are as close as possible to the actual net cost of the asset, all preclude petitioner from deducting depreciation on the *Feuer* after having sold it for more than its depreciated cost. The judgment of the court of appeals should therefore be affirmed.

Respectfully submitted.

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OCTOBER 1965.

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*In lieu of the Solicitor General, who has disqualified himself.

[illegible]

[illegible]

Respectfully submitted,

[illegible]

Acting Solicitor General.

[illegible]

Attorneys.

[illegible]

APPENDIX

Internal Revenue Code of 1954:

SEC. 167. DEPRECIATION.

(a) *General Rule.*—There shall be allowed as a depreciation deduction a reasonable allowance for the exhaustion, wear and tear (including a reasonable allowance for obsolescence)—

(1) of property used in the trade or business, or

(2) of property held for the production of income.

(b) *Use of certain methods and rates.*—For taxable years ending after December 31, 1953, the term "reasonable allowance" as used in subsection (a) shall include (but shall not be limited to) an allowance computed in accordance with regulations prescribed by the Secretary or his delegate, under any of the following methods:

(1) the straight line method,

*   *   *   *   *

[26 U.S.C. 167.]

SEC. 1231. PROPERTY USED IN THE TRADE OR BUSINESS AND INVOLUNTARY CONVERSIONS.

(a) *General Rule.*—If, during the taxable year, the recognized gains on sales or exchanges of property used in the trade or business, plus the recognized gains from the compulsory or involuntary conversion (as a result of destruction in whole or in part, theft or seizure, or an exercise of the power of requisition or condemnation or the threat or imminence thereof)

of property used in the trade or business and capital assets held for more than 6 months into other property or money, exceed the recognized losses from such sales, exchanges, and conversions, such gains and losses shall be considered as gains and losses from sales or exchanges of capital assets held for more than 6 months. If such gains do not exceed such losses, such gains and losses shall not be considered as gains and losses from sales or exchanges of capital assets. * * *

* * * * *

[26 U.S.C. 1231.]

Treasury Regulations on Income Tax (1954 Code):

Sec. 1.167(a)-1 *Depreciation in general.*

(a) ***Reasonable allowance.*** Section 167(a) provides that a reasonable allowance for the exhaustion, wear and tear, and obsolescence of property used in the trade or business or of property held by the taxpayer for the production of income shall be allowed as a depreciation deduction. The allowance is that amount which should be set aside for the taxable year in accordance with a reasonably consistent plan (not necessarily at a uniform rate), so that the aggregate of the amounts set aside, plus the salvage value, will, at the end of the estimated useful life of the depreciable property, equal the cost or other basis of the property * * *. An asset shall not be depreciated below a reasonable salvage value under any method of computing depreciation. See paragraph (c) of this section for definition of salvage. The allowance shall not reflect amounts representing a mere reduction in market value. * * *

(b) ***Useful life.*** For the purpose of section 167 the estimated useful life of an asset is not necessarily the useful life inherent in the asset but is the period over which the asset may reasonably be expected to be useful to the tax-

payer in his trade or business or in the production of his income. This period shall be determined by reference to his experience with similar property taking into account present conditions and probable future developments. Some of the factors to be considered in determining this period are (1) wear and tear and decay or decline from natural causes, (2) the normal progress of the art, economic changes, inventions, and current developments within the industry and the taxpayer's trade or business, (3) the climatic and other local conditions peculiar to the taxpayer's trade or business, and (4) the taxpayer's policy as to repairs, renewals, and replacements. Salvage value is not a factor for the purpose of determining useful life. If the taxpayer's experience is inadequate, the general experience in the industry may be used until such time as the taxpayer's own experience forms an adequate basis for making the determination. The estimated remaining useful life may be subject to modification by reason of conditions known to exist at the end of the taxable year and shall be redetermined when necessary regardless of the method of computing depreciation. However, estimated remaining useful life shall be redetermined only when the change in the useful life is significant and there is a clear and convincing basis for the redetermination. For rules covering agreements with respect to useful life, see section 167(d) and § 1.167(d)-1.

(c) *Salvage.* Salvage value is the amount (determined at the time of acquisition) which is estimated will be realizable upon sale or other disposition of an asset when it is no longer useful in the taxpayer's trade or business or in the production of his income and is to be retired from service by the taxpayer. Salvage value shall not be changed at any time after the determination made at the time of acquisition merely because of changes in price

levels. However, if there is a redetermination of useful life under the rules of paragraph (b) of this section salvage value may be redetermined based upon facts known at the time of such redetermination of useful life. * * * Salvage value must be taken into account in determining the depreciation deduction either by a reduction of the amount subject to depreciation, or by a reduction in the rate of depreciation, but in no event shall an asset or an account be depreciated below a reasonable salvage value. * * *

* * * * *

Sec. 1.167(a)–10 *When depreciation deduction is allowable.*

* * * * *

(b) The period for depreciation of an asset shall begin when the asset is placed in service and shall end when the asset is retired from service. A proportionate part of one year's depreciation is allowable for that part of the first and last year during which the asset was in service. * * *

* * * * *

Sec. 1.167(b)–0 *Methods of computing depreciation.*

(*a*) *In General.* Any reasonable and consistently applied method of computing depreciation may be used or continued in use under section 167. Regardless of the method used in computing depreciation, deductions for depreciation shall not exceed such amounts as may be necessary to recover the unrecovered cost or other basis less salvage during the remaining useful life of the property. The reasonableness of any claim for depreciation shall be determined upon the basis of conditions known to exist at the end of the period for which the return is made. It is the responsibility of the taxpayer to establish the reasonableness of the deduction for depreciation claimed. Generally,

depreciation deductions so claimed will be changed only where there is a clear and convincing basis for a change.

* * * * *

Sec. 1.167(b)-1 *Straight line method.*

(a) *Application of method.* Under the straight line method the cost or other basis of the property less its estimated salvage value is deductible in equal annual amounts over the period of the estimated useful life of the property. The allowance for depreciation for the taxable year is determined by dividing the adjusted basis of the property at the beginning of the taxable year, less salvage value, by the remaining useful life of the property at such time. * * *

* * * * *

Rev. Rul. 62-92, 1962-1 Cum. Bull. 29:

> The depreciation deduction for the taxable year of disposition of an asset used in the trade or business or in the production of income, otherwise properly allowable under the taxpayer's method of accounting for depreciation, is limited to the amount, if any, by which the adjusted basis of the asset at the beginning of the year exceeds the amount realized from sale or exchange.

Advice has been requested whether the Internal Revenue Service will apply the decision of the United States Court of Appeals in the case of *Bertrand W. Cohn, et al.,* v. *United States,* 259 Fed. (2d) 371, (1958), to the extent that the deduction for depreciation of an asset used in a trade or business will be adjusted in the year of disposition of the asset if the amount received from disposition exceeds the adjusted basis of the asset as of the beginning of the taxable year.

* * * * *

The provision in section 1.167(a)-1(c) of the regulations to the effect that salvage value shall

not be changed at any time after the determination made at the time of acquisition merely because of changes in price levels applies to assets still on hand. The provision does not preclude adjustment of salvage value where there is a clear and convincing basis therefor even though no adjustment of useful life is required. The purpose of the provision is to eliminate needless and endless controversies over depreciation allowances which at best are merely informed estimates of the cost of using the property in the taxpayer's business. That purpose has been served when the asset is disposed of and when a final transaction has occurred over which there can be no dispute or difference of opinion or judgment. These rules are and have always been applicable to the allowance of the deduction for depreciation. See *Massey Motors, Inc.* v. *United States* and *Commissioner* v. *Robley H. Evans et ux.*, 364 U.S. 92 (1960), Ct. D. 1847, C.B. 1960–2, 445; and *Hertz Corporation* v. *United States*, 364 U.S. 122 (1960), Ct. D. 1848, C.B. 1960–2, 70.

Accordingly, it is the position of the Service that the *Cohn* case applies equally to the 1939 Code and the 1954 Code and that it is not only reasonable but proper to take the ultimate facts into consideration in determining the depreciation deduction for the year of disposition of the asset. Therefore, the deduction for depreciation of an asset used in the trade or business or in the production of income shall be adjusted in the year of disposition so that the deduction, otherwise properly allowable for such year under the taxpayer's method of accounting for depreciation, is limited to the amount, if any, by which the adjusted basis of the property at the beginning of such year exceeds the amount realized from sale or exchange. See also section 1.167(a)–10 of the regulations for rules with respect to when depreciation is allowable.

* * * * *

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1965

No. 23

FRIBOURG NAVIGATION COMPANY, INC.,
Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

REPLY BRIEF FOR THE PETITIONER

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TABLE OF CONTENTS

TABLE OF CITATIONS

PAGE

STATUTES:

MISCELLANEOUS:

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ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

REPLY BRIEF FOR THE PETITIONER

I. The Commissioner Has Failed to Reconcile the Treatment of Sales at a Loss with His Position in this Case.

The established rules relating to sales of depreciable property at a loss completely undermine the Commissioner's position. Yet the Commissioner cannot reconcile—and in his brief he has not attempted to reconcile—the treatment of losses with his position in this case.

The Commissioner says that estimated useful life and salvage value are mere temporary expedients that must yield to the actual period of use and sales price when the latter become known (Resp. Br. 5, 16, 18-19). The Commissioner arbitrarily assumes that "depreciation is intended to give the taxpayer deductions which are, in total, as nearly equal to the actual net cost [which he defines as cost less actual sales price] of the asset being depreciated as possible" (Resp. Br. 19; *id.*, 5, 12), and he concludes that deprecia-

tion for the year of sale should be revised to achieve this objective (*id.*, 6, 7, 15, 16).

If the Commissioner's line of reasoning were correct, it would have to apply to sales of depreciable property at a loss as well as to sales at a gain. If the "real salvage price" replaces the "false assumption" and fixes "actual net cost" (Resp. Br. 22-23), it does so regardless of whether it exceeds or is less than adjusted basis at the beginning of the year of sale. If depreciation for the year of sale is to be conformed to "actual net cost," the depreciation deduction for the year of sale at a loss must be increased by the amount of that loss. As a result, what has always been regarded as a loss on the sale of depreciable property would instead be deductible as additional depreciation for the year of sale.[1]

The Commissioner's "actual net cost" theory would thus render meaningless the elaborate structure of income tax provisions requiring losses on sale of depreciable property to be offset against amounts otherwise reportable as capital gain; to be treated as capital losses where the property was income-producing but not a business asset; or, under various circumstances, to be totally nonrecognized (Pet. Br. 39). Similarly, the long history of Congressional struggle with the tax treatment of losses from sales of depreciable property in the Revenue Acts of 1921, 1938 and 1942 (Pet. Br. 32-34) would have been devoted to a nonexistent problem.

We discussed this point in our earlier brief (Pet. Br. 39-40), but the Commissioner's brief is silent on it. He has no answer to the refutation of his position by the rules relating to sales of depreciable property at a loss.

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[1]Even if inadequate depreciation had been taken for previous years, loss on sale would still be eliminated, for the basis of depreciable property must be reduced for allowable depreciation even though a lesser amount has been allowed. Int. Rev. Code of 1954, § 1016(a)(2). This adjustment affects both the basis for determining gain or loss and the basis for depreciation. Int. Rev. Code of 1954, §§ 167(g) and 1011. As a result, the basis for depreciation can never be less than the adjusted basis for determining loss.

II. The Commissioner Errs in Asserting That There Is No Long-Standing Administrative Practice Contrary to His Position.

The Commissioner disagrees with our argument that his position in this case is contrary to more than four decades of administrative practice allowing depreciation for the year of profitable sale (Resp. Br. 34, 44). He attempts to date his present position back at least to 1942. However, his attempt is plainly refuted by the sudden emergence of hundreds of court cases contesting disallowance of year-of-sale depreciation. This case—the most advanced of the lot—was docketed in the Tax Court late in 1960. More than 300 such cases are now in litigation.[2] There is only one explanation for the heavy current case load involving this issue when there was none five years ago: the Commissioner suddenly reversed his position.

We cited in our earlier brief, as proof of the Commissioner's long administrative practice of allowing year-of-sale depreciation, twenty-four court cases reflecting such administrative allowances (Pet. Br. 19-21), four published rulings (*id.*, 21), the Commissioner's successful demand that the depreciation be taken even though it produced no tax benefit (*id.*, 23), his acquiescence in a Tax Court decision allowing such depreciation (*id.*, 25), provisions of the income tax regulations (*id.*, 25-27), and the Commissioner's disavowal on brief in the *Cohn* and *Massey* cases of the position he urges here (*id.*, 43-45, 47-48). We had supposed that further proof would be merely cumulative, but since the Commissioner, to our surprise, denies the ad-

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[2]This figure was recently obtained informally from the Internal Revenue Service. The Government's petition for certiorari in *United States* v. *S & A Co.,* No. 50, this Term, p. 5, states that 178 such cases were in litigation as of September 1964.

ministrative practice, additional citations may refresh his recollection:

(a) In *Crane* v. *Commissioner,* 331 U. S. 1 (1947), the Commissioner allowed the $3,200 of depreciation claimed by the taxpayer for the year of profitable sale of a building. *Beulah B. Crane,* 3 T. C. 585, 587 (1944). This Court sustained the Commissioner's determination of gain based upon allowance of such depreciation.

(b) In S. M. 2112, III-2 C. B. 22 (1924), the Commissioner held that in computing gain on sale of a leasehold in May, 1919, the basis of the leasehold had to be reduced "because of the exhaustion of the lease due to the lapse of time. . . . [A]t the date of the sale, a large part of the property value as of March 1, 1913, had ceased to exist. The true gain or loss from the sale of property can not be arrived at except through a comparison of the basic price and the sale price of the same property. To compare the basic price of the entire property with the sale price of only a part of the property clearly does not give the true gain or loss."

(c) In *C. B. Shaffer,* 29 B. T. A. 1315 (1934), a partnership had failed to claim depreciation on its oil refinery and producing equipment for the period January 1, 1919 to the date of its profitable sale on May 31, 1919. However, said the Board, "The respondent admits that the partnership is entitled to depreciation for the period." 29 B. T. A. at 1324. The Board then proceeded to fix the rates of depreciation for that period.

(d) In each of the following additional cases the Commissioner allowed depreciation for the year of profitable sale: *F. A. Gillespie & Sons Co.* v. *Commissioner,* 154 F. 2d 913, 915 (10th Cir. 1946); *Seymour Mfg. Co.* v. *Burnet,* 56 F. 2d 494, 495-496 (D. C. Cir.

1932); *M. Hilty Lumber Co.* v. *United States,* 3 F. Supp. 657 (Ct. Cl. 1933); *Gunnison Sugar Co.* v. *Hinckley,* 32 A. F. T. R. 1666, 1668 (D. Utah 1942), *rev'd,* 139 F. 2d 492 (10th Cir. 1943); *George Blodgett Co.* v. *Ham,* 16 A. F. T. R. 1003 (D. Me. 1934); *United States* v. *Farrell,* 35 F. 2d 38, 39 (D. Conn. 1929); *Nocona Cotton Seed Oil Co.,* 42 B. T. A. 1172, 1175, 1178 (1940); *Emily N. Vanderpoel Trust,* 3 B. T. A. 372, 374 (1926); *William Ziegler, Jr.,* 1 B. T. A. 186, 192 (1924); *H. L. Gatlin,* T. C. Memo. 1960-23, 19 CCH T. C. Memo. 131, 132 (1960); *P. H. & J. M. Brown Co.,* T. C. Memo. 1959-162, 18 CCH T. C. Memo. 708, 709 (1959); *Elizabeth Operating Corp.,* T. C. Memo. 112709, 2 CCH T. C. Memo. 817, 818 (1943).

(e) The income tax statute provides a "reasonable allowance" for depletion as well as for depreciation.[8] As this Court has recognized, the common purpose of both these allowances is to permit the tax-free return of capital through writeoff of wasting assets. *Parsons* v. *Smith,* 359 U. S. 215, 220 (1959); *Anderson* v. *Helvering,* 310 U. S. 404, 408 (1940). The Commissioner's consistent practice over the years has been to allow depletion as well as depreciation for the year of profitable sale. *United States* v. *Ludey,* 274 U. S. 295 (1927); *Eldorado Coal & Mining Co.* v. *Mager,* 255 U. S. 522 (1921); *F. A. Gillespie & Sons Co.* v. *Commissioner, supra; M. Hilty Lumber Co.* v. *United States, supra; C. E. Wentz, Trustee,* 26 B. T. A. 868, 869 (1932); *Barnett Anchor Oil Co.,* 25 B. T. A. 746, 749 (1932).

To present in convenient form the Commissioner's practice, we show, in an Appendix hereto, for 36 of the court

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[8]*Compare* Int. Rev. Code of 1954, § 611(a) *with id.,* § 167(a).

decisions and rulings cited above and in our earlier brief, the date of profitable sale, the type of property sold, whether gain on the sale qualified for the favorable capital gains rate,[4] and the allowance of depreciation or depletion made for the year of sale. These decisions and rulings demonstrate beyond doubt that from the advent of the income tax until 1960, the Commissioner interpreted and administered the depreciation statute by allowing depreciation for the year of profitable sale on the basis of the reasonable estimates of useful life and salvage value employed for prior years.

The Commissioner attempts to dismiss the rulings and cases on which we rely because they dealt with tax years before 1922, when sales of depreciable property first became eligible for capital gain treatment (Resp. Br. 34-35). However, twenty-one of the cases and rulings summarized in the Appendix involved sales made after 1921; and eight of such 21 cases involved gains that clearly qualified for the favorable capital gains rate. From 1913 until 1960 (a period of 47 years during 34 of which depreciable property was eligible for capital gain) there were only two cases[5] in which taxpayers challenged disallowance of reasonable estimated depreciation for the year of profitable sale—and in both cases the Tax Court held the depreciation was allowable (Pet. Br. 22, 23-24). The lack of any other litigation of that issue, which must have been presented in hundreds

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[4]Some of the gains realized during 1922-1937 or after 1941 failed to qualify for the favorable capital gains rate for lack of sufficient holding period or for other reasons.

[5]*Duncan-Homer Realty Co.*, 6 B. T. A. 730 (1927), and the automobile issue in *Wier Long Leaf Lumber Co.*, 9 T. C. 990 (1947), *aff'd and rev'd on other issues*, 173 F. 2d 549 (5th Cir. 1949). The *Cohn* decision in 1958 did not involve the issue (Pet. Br. 43-45). Isolated instances of inconsistency such as are represented by these two attempted disallowances "can be found in most areas where the volume of cases is as large as it is here." *Massey Motors, Inc.* v. *United States*, 364 U. S. 92, 103, note 5 (1960).

of returns every year, speaks for itself as to the extraordinary degree of administrative consistency in allowing depreciation for the year of profitable sale.

The course of administrative practice since 1942 also speaks for itself. The last eight cases listed in the Appendix were decided after 1942, and the last five involved years affected by the 1942 capital gain legislation. The acquiescence in the automobile issue in the *Wier* case was outstanding from 1948 until 1962 (Pet. Br. 25, 40). The example in the income tax regulations of allowance of depreciation for the year of profitable sale was outstanding from 1951 until 1965 (Pet. Br. 26, 40). The Government's briefs in the *Cohn* and *Massey* cases, written in 1958-1960, disavowed the existence of the practice the Commissioner now seeks to date back to 1942.[6] The current depreciation regulations, issued in 1956, are out of harmony with that practice (Pet. Br. 25-26). As we have noted, the hundreds of pending cases protesting that practice did not begin accumulating until 1960.[7]

The Commissioner also attempts to disparage the early rulings and court decisions on the ground that they were not "focused on the issue presented here" because they were "occupied with establishing the basic ground rules for computing depreciation and determining the amount of gain on sale"[8] (Resp. Br. 36, 37). However, this case involves a basic ground rule for computing depreciation and gain on

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[6]See p. 3, *supra*.

[7]See p. 3, *supra*.

[8]The Commissioner also erroneously suggests that two of the published rulings requiring depreciation to date of sale—G. C. M. 1597, VI-1 C. B. 71 (1927) and I. T. 1494, I-2 C. B. 19 (1922)—did not clearly involve gain on sale (Resp. Br. 35-36). However, G. C. M. 1497 expressly states that "the question has arisen as to the adjustment for depreciation in determining the profit from the transaction" (VI-1 C. B. at 71); and I. T. 1494 found that "there was a gain" and that it was not taxable (I-2 C. B. at 21)—not, as respondent asserts, that no gain existed.

sale. When the great volume of authority contrary to the Commissioner's present position was developed, it was a universally understood ground rule that depreciation was allowable up to the date of sale. Furthermore, we are unaware of any doctrine that a long-continued and consistent administrative practice, published rulings, court decisions, acquiescences, Congressional committee reports, and Treasury regulations should be disregarded because the Commissioner thinks he "failed to focus upon the issue" (Resp. Br. 35).

Moreover, the authorities in question do not suffer from the alleged lack of focus. The issue was squarely presented and squarely adjudicated in the *Simons* case and with respect to the automobiles in the *Wier* case (Pet. Br. 23-24). The other precedents repeatedly showed a full awareness of the issue and a keen perception of depreciation principles. For example: (a) This Court recognized in *Ludey* the importance of separating "the original cost of the whole" plant into the two elements necessary to a fair determination of depreciation and gain on sale: "the cost of the part" of which "a gradual sale is made" by being used up and "the cost of that disposed of in the final sale." 274 U. S. at 301. (b) The language quoted at p. 4 *supra*, from S. M. 2112 shows an understanding that the cost of a leasehold must also be fairly allocated between the portion used up and the portion that "had ceased to exist" at the time of the final sale. (c) Even earlier the Board of Tax Appeals in *Even Realty Co.,* 1 B. T. A. 355 (1925), had clearly focused upon the subject:

> "* * * The [Corporation Tax A]ct of 1909 said 'a reasonable allowance for depreciation of property, if any.' The Revenue Act of 1913 restricted the deduction to an allowance for depreciation *by use, wear, and tear.* And the later revenue acts elimi-

> nated the word ***depreciation*** entirely (see p. 359, *supra*). There is nothing in any of the revenue acts subsequent to the Sixteenth Amendment which would have precluded the taxpayer from taking a reasonable deduction for *wear and tear* upon its building, even though the building itself might have appreciated in value at the same time.
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> "Depreciation in its broad sense, like appreciation, may be due to extrinsic causes, but that is not true of *wear and tear*. There is no reason why *wear and tear,* purely intrinsic matters, need be tied up to *appreciation* resulting from extrinsic causes. The two can go on simultaneously and no provision of law requires the one to be offset against the other. * * *" 1 B. T. A. at 361. (Emphasis in original.)

Proceeding from the above analysis the Board held, with respect to the taxpayer's profitable sale of an office building during the year 1920, that the cost of the building "should be adjusted by proper allowance for exhaustion, wear and tear and obsolescence from date of acquisition to date of sale, and the adjusted cost subtracted from the sale price to determine the gain upon the sale." 1 B. T. A. at 365.

The Commissioner attempts to disregard as "internally inconsistent" and not "important" the decision against him in the *Wier* case and his prompt acquiescence therein[9] (Resp. Br. 40). However, the stipulation on the automobile issue in the *Wier* case was clearly designed to present squarely the question whether, as a matter of law, the sales price received on a profitable sale of property limits the amount of depreciation allowable for the year of sale.

[9] *Wier Long Leaf Lumber Co.*, 9 T. C. 990 (1947), *acq.*, 1948-1 C. B. 3 (withdrawn), *nonacq.*, 1962-1 C. B. 5, *aff'd and rev'd on other issues*, 173 F. 2d 549 (5th Cir. 1949), discussed at Pet. Br. 23-25.

The Commissioner's prompt acquiescence in the allowance of year-of-sale depreciation on the automobiles was an acknowledgment that there was no such rule of law (Pet. Br. 25). The disallowance of depreciation on the sawmill is not inconsistent with the decision on the automobile issue, but was a factual holding that petitioner had not "met its burden of proof" as to the proper amount of depreciation on the sawmill, since it introduced "no evidence" of salvage value. 9 T. C. at 998, 999.

The Commissioner errs in asserting that the regulation showing depreciation to be allowable in the year of profitable sale should be given no effect because he was "at the same time judicially attacking the deductibility of such depreciation" (Resp. Br. 42, note 27). This regulation was initially issued in 1951 under the Internal Revenue Code of 1939 as part of Regs. 111, was reissued in 1953 in Regs. 118, and then reissued again in the 1954 Code regulations in 1957.[10] Respondent's decision to attack the deductibility of depreciation in the year of sale did not occur until years later.[11] Furthermore, the regulation was directly drawn from an example in the Congressional committee reports showing depreciation to be allowable in the year of profitable sale.[12]

Respondent's further assertion that the example in the regulations was "obscure and unconsidered" is likewise without foundation (Resp. Br. 42). The example in the regulation illustrated operation of a statutory provision aimed at exactly the situation now in issue—the fact that depreciation and amortization deductions offset ordinary income, while gain from sale of depreciable property may be taxed as capital gain. Both the Treasury and Congress were aware of this problem, for the Treasury had recently

[10]Pet. Br. 26-27, and notes 33 and 34.
[11]Pet. Br. 40, 47-48 and note 90; p. 3, *supra*.
[12]Pet. Br. 34-35 and note 54.

requested, and been refused, legislation to alter capital gain treatment on such sales (Pet. Br. 34-35). The example in the regulation and Congressional committee reports reflects the continued universal understanding that depreciation was allowable to the date of profitable sale. The many instances of alleged lack of "focus on the issue" are really reflections of the deeply embedded administrative practice.

The administrative, judicial and legislative precedents reflecting allowance of depreciation for the year of profitable sale do not suffer from the conflict or shortness of duration referred to in the exceptions cited by respondent to the enactment rule (Resp. Br. 44-46; see Pet. Br. 31-41). This is not a case of an isolated ruling, an occasional case, or an administrative practice not necessarily known to Congress, but a principle set forth in a series of rulings, reflected in a vast number of cases, expressly approved when placed in issue, acquiesced in by the Commissioner, and embodied in Congressional committee reports and Treasury regulations. Those numerous precedents evidence an administrative practice "long continued and substantially uniform in the Bureau and without challenge." *Higgins v. Commissioner*, 312 U. S. 212, 216 (1941).

III. The Commissioner Is Not Aided by His Argument That Section 1231 Does Not Conflict with His Interpretation.

We concur with the Commissioner's assertion that section 1231 deals only with how gain or loss on sale of a depreciable asset will be taxed (Resp. Br. 28-32), but we do not see how the assertion aids him. Our contention that a "reasonable allowance" for depreciation comprehends an allowance continuing to the date of sale is based on the language and the history of the interpretation of section 167. The Commissioner agrees that "[n]othing in the lan-

guage or history of [section 1231 and its predecessor] indicates any Congressional attempt to affect in any manner the orderly judicial elaboration of the phrase a 'reasonable allowance for' 'depreciation' in [s]ection 167" (Resp. Br. 29). As the Tax Court has stated:

> "We do not believe that the mere enactment of the predecessor of section 1231, which simply provided that gains on the sale or exchange of depreciable property held for more than six months would be considered as capital gains, also changed in any way the previously existing statutory scheme providing for (1) the depreciation of an asset up to the time of sale and (2) the taxation of any gain or loss realized upon the sale of such an asset, as a result of market conditions, pursuant to the applicable provisions relating to gain or loss." *Macabe Co.,* 42 T. C. 1105, 1117 (1964), on appeal to 9th Cir.

IV. The Commissioner Errs in Asserting That Commercial Accounting Principles are Irrelevant.

Recognizing that our position is squarely supported by business accounting principles, the Commissioner blandly dismisses those principles as irrelevant for income tax purposes (Resp. Br. 25-27). However, as even the Commissioner concedes, generally accepted accounting practices have been rejected in tax cases only "when they fail clearly to report income for tax purposes" (Resp. Br. 25).[13] In fairness he should have added, as he did in a recent ad-

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[13]None of the cases cited by the Commissioner involved the depreciation provision. *American Automobile Association* v. *United States,* 367 U. S. 687 (1961), involved the time of accrual of prepaid income; *Commissioner* v. *Hansen,* 360 U. S. 446 (1959) involved the time of accrual of automobile dealers' reserves; *Bazley* v. *Commissioner,* 331 U. S. 737 (1947), involved the definition of a reorganization; and *Brown* v. *Helvering,* 291 U. S. 193 (1934) involved the time of accrual of contingent liabilities.

dress, that the areas in which tax policy require a departure from commercial accounting are the exception, not the rule.[14] "Basically," said the Commissioner in that address, "the objective of both commercial and tax accounting is to establish procedures which will result in the proper determination of net income."

Unsurprisingly, the Commissioner's address—rather than his brief in this case—echoes the view of this Court. "Accounting for financial management and accounting for federal income tax purposes both focus on the need for an accurate determination of the net income from operations of a given business for a fiscal period." *Massey Motors, Inc.* v. *United States,* 364 U. S. 92, 106 (1960). In reaching a conclusion in *Massey* harmonious with that of commercial accounting, this Court cited writers in the nontax accounting field in support of that conclusion. *Ibid,* note 7.

The Commissioner attempts to drive a wedge between tax and commercial accounting for depreciation by mistakenly asserting that they seek to accomplish different purposes. (Resp. Br. 26-27.) Contrary to the Commissioner's assertion, commercial accounting—as well as tax accounting—limits depreciation to cost.[15] The basic depreciation

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[14]Address of Commissioner of Internal Revenue to American Institute of Certified Public Accountants at Dallas, Texas on September 20, 1965, reported in 22 Tax Barometer No. 43, ¶ 1722 (September 24, 1965).

[15]"Depreciation, from the accounting point of view, deals strictly with the question of the replacement of wasting assets at cost." Saliers, Depreciation Principles and Applications 69 (3d Ed. 1939). "In making an allowance for depreciation, the point of view of the accountant is backward toward original cost. . . ." I Dewing, The Financial Policy of Corporations 544 (5th Ed. 1953). "Depreciation is the gradual writing off of the cost of the fixed property of a business—the amortization of the original money cost of the asset—over successive income periods." *Id.* at 543. The "essential conception" of depreciation accounting "is that of assigning the cost of property to the accounting periods included in useful life." Paton, Accountants' Handbook 711 (3d Ed. 1944).

formula of the income tax regulations is identical with that of authorities on business accounting.[16]

The Commissioner misrepresents the function of financial accounting as that of "avoiding any overstatement of current net income from operations" (Resp. Br. 26). The suggestion that the financial accountant is free to understate but not to overstate net income is patently incorrect. The true function of financial accounting—as stated by this Court in the *Massey* case—is "accurate determination of the net income from operations." 364 U. S. at 106. That function—indeed, the essential purpose of both tax and financial accounting—with respect to depreciation is the making of "a meaningful allocation of the cost entailed in the use . . . of the asset to the periods to which it contributes." *Id.* at 104. That meaningful allocation requires an allowance for depreciation for the period of use of the asset during the year of sale, and a reduction of basis by such depreciation to obtain a fair reflection of gain on sale.

V. The Commissioner Errs in Asserting That Depreciation Should Be Measured by "Actual Net Cost."

The core of the Commissioner's brief is the contention that a taxpayer's depreciation deductions cannot exceed the "actual net cost" of the asset's use in the taxpayer's business (Resp. Br. 5, 6, 14, 17, 19, 22, 47). By comparing the taxpayer's January 1, 1957 adjusted basis ($326,628)

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[16] *Compare* Treas. Reg. § 1.167(a)-1(a) and (c) *with* the following:

"*Depreciation accounting* is a system of accounting which aims to distribute the cost or other basic value of tangible capital assets, less salvage (if any), over the estimated useful life of the unit . . . in a systematic and rational manner." American Inst. of Accountants, Committee on Terminology, Terminology Bulletin No. 1, p. 25 (1953). "The factors necessary to the computation of the current accounting period's depreciation charge are (a) original cost, (b) estimated life, and (c) estimated salvage value." Saliers, *op. cit. supra* 160.

with the December, 1957 sale price ($695,000), the Commissioner concludes that the taxpayer had no "actual net cost" for the use of the *Feuer* during 1957. The taxpayer knew "its use of the ship during 1957 had cost it nothing" (Resp. Br. 2, 4, 10, 19, 24, 46).

Despite its beguiling simplicity, the Commissioner's argument is utterly fallacious. The conclusion that use of the *Feuer* during 1957 cost the taxpayer nothing is based not on "actual facts," as the Commissioner asserts (Resp. Br. 5, 16, 19), but on wholly arbitrary assumptions as to the manner in which the cost of the *Feuer* should be allocated against the income produced by it. The *Feuer*, having suffered wear, tear and obsolescence during 1957, was not the same asset in December as in January of that year. The Commissioner ignores this fact, however, and applies the entire adjusted basis of the *Feuer* as of January 1, 1957 against the sales price of the more consumed asset sold in December, 1957. This mismatching of the cost of the less consumed asset against the sales price received almost a year later for the more consumed asset distorts both the gain realized on sale of the *Feuer* and the income produced from its consumption during 1957.

The mismatching of the cost of the less used asset against the sales price of the more used asset directly violates the principles of *United States* v. *Ludey, supra,* p. 5. "When the plant is disposed after years of use, the thing then sold is not the whole thing originally acquired." The "cost of that disposed of in the final sale" is less than the "original cost of the whole"; the difference is the cost of what has been consumed through use. See 274 U. S. at 301. By the same token, an exhaustible asset sold at the end of a given year is not the "whole thing" existing at the beginning of the year. A portion of the asset has been consumed during the year. The arbitrary lumping of the cost of the whole against the price received for a part—thus denying any al-

location to the income produced by the part consumed during the year—is a distorted method of cost allocation.

The distortion may readily be seen in the case of a taxpayer who purchases for $100,000 a royalty-producing patent that will expire in five years and resells it at the end of the fourth year. Under the straight-line method of depreciation, the taxpayer would write off $80,000 against the four years of royalty income received by him and the remaining $20,000 against the sales price (representing the value of his right to the fifth year's royalties.)[17] If the royalty yield has reached $40,000 a year, he will have net income of $20,000 for the fourth year and a profit on sale of about the same amount. However, under the Commissioner's approach the right to the fifth year's royalties cost the taxpayer $40,000 and the fourth year's royalties cost him nothing.

Similarly, if a taxpayer buys land with timber upon it for $10,000, cuts down the timber, and later sells the land for $11,000, his gain on the sale cannot properly be computed without reference to the cutting of the timber.[18] The total cost should be allocated between land and timber on the basis of the facts existing at the time of purchase, and the portion of the cost allocable to the timber written off as depletion deductions as the timber is cut. If one-third of the timber is cut in each of two years and the land is sold at the end of the second year with one-third of the timber still standing, one-third of the cost of the timber should be deducted for the second year, and one-third of its cost should enter into the computation of gain on the sale. However, the Commisisoner's theory would lead to the absurd conclusions that two-thirds of the timber cost should be allo-

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[17]Since a patent—like a copyright or a leasehold—has no salvage value, its entire cost is written off over its useful life. Treas. Reg. §§ 1.167(a)-4 and 1.167(a)-6(a).

[18]The Board of Tax Appeals used this example in its decision in *Even Realty Co., supra* pp. 8-9, at 358.

cated to the one-third sold and that the one-third of the timber cut in the second year cost the taxpayer nothing.

To protect the cost allocation process the regulations define "useful life" and "salvage value" as factors to be determined at the time of acquisition of the property.[19] The prohibition in the regulations against changing estimated salvage value to reflect changes in price levels is not a mere administrative convenience, as the Commissioner contends (Resp. Br. 14, 18); instead, the prohibition is basic to the cost allocation concept. The regulations reflect the fundamental principle that changes in price levels should not disturb the process of cost allocation involved in depreciation, a principle that applies whether or not the change in price level is realized through sale.[20]

The Commissioner attempts to support his theory by reading the regulations as though they read "actual sales price" wherever they actually speak of "salvage value" as defined in section 1.167(a)-1(c). By the same type of unwarranted substitution he misreads what this Court said in validating the regulations in the *Massey* and *Hertz* cases. Every reference to salvage value in the regulations and in the *Massey* and *Hertz* cases is in terms of estimates; yet the Commissioner cites them throughout as though they spoke of "actual sales price" and thus validated his "actual net cost" theory (Resp. Br. 17, 19, 22, 23).

To discard useful life and salvage value as defined in the regulations in favor of the actual period of use and sales price when the latter become known would destroy the framework of the cost allocation process. By that process the cost of the portion of the property consumed in business operations is separated from the cost of the portion disposed of on sale. The regulations do not mysteriously neglect to

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[19]Treas. Reg. § 1.167(a)-1(b) and (c).

[20]*Even Realty Co., supra* pp. 8-9, at 361; *Max Eichenberg*, 16 B. T. A. 1368, 1370 (1929); *Whitelite Electric Co.*, 18 B. T. A. 934, 936 (1930); *Wier Long Leaf Lumber Co., supra* note 4, p. 9.

deal with the event of sale; instead, they refrain from supplanting salvage value as defined in section 1.167(a)-1(c) because that would destroy the only conceivable way of fairly separating depreciation from capital gain.

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APPENDIX

	Decision or ruling	Date of profitable sale	Type of property	Tax classification of gain	Relevant allowance for year of sale
1.	Eldorado Coal & Mining Co. v. Mager, 255 U.S. 522, 526 (1921)	May, 1917	Coal mine and mining plant	Ordinary	Depreciation and depletion to the date of sale subtracted to determine basis for gain on sale.
2.	I.T. 1494, I-2 Cum. Bull. 19 (1922)	1917	Unstated	Ordinary	Property depreciated to date of sale, to $40,000, in the year of its sale for $47,000.
3.	Grosvenor Atterbury, 1 B.T.A. 169, 170 (1924)	June 17, 1920	Leasehold	Ordinary	$2,970.51 depreciation allowed for 5-17/30 months of 1920 to date of sale.
4.	William Ziegler, Jr., 1 B.T.A. 186, 192 (1924)	July 1, 1919	Buildings	Ordinary	Commissioner computed depreciation at 2% rate to date of sale.
5.	S.M. 2112, III-2 Cum. Bull. 22 (1924)	May, 1919	Leasehold	Ordinary	Deduction authorized for exhaustion of the lease due to lapse of time.
6.	Even Realty Co., 1 B.T.A. 355, 356 (1925)	1920	Office building	Ordinary	Depreciation allowed to date of sale at rate of 2% per annum.
7.	W. W. Carter Co., 1 B.T.A. 849, 851 (1925)	January 30, 1920	Leasehold	Ordinary	Deduction for exhaustion of lease computed to date of sale.
8.	Marchetti Roma Cafe Co., 2 B.T.A. 529, 530 (1925)	December 3, 1921	Restaurant equipment	Ordinary	Depreciation claimed and allowed for year of sale.
9.	Emily N. Vanderpoel Trust, 3 B.T.A. 372, 373-374 (1926)	May 1, 1920	Building	Ordinary	Depreciation computed at rate of 3% per annum to determine basis for gain on sale.
10.	Capital City Investment Co., 4 B.T.A. 933, 935 (1926)	May 28, 1919	Leasehold	Ordinary	Deduction for exhaustion of lease computed to date of sale.
11.	United States v. Ludey, 274 U.S. 295 (1927)	February, 1917	Oil leases and production equipment	Ordinary	Depreciation and depletion allowed to date of sale. (Pet. Br. 19-20.)
12.	G.C.M. 1597, VI-1 Cum. Bull. 71 (1927)	1926	Improved real estate	Capital	Depreciation for the portion of the year 1926 up to the date of sale subtracted to determine basis of property.
13.	Duncan-Homer Realty Co., 6 B.T.A. 730, 731-732 (1927)	1923	Improved real property	Ordinary	Board of Tax Appeals ruled that the taxpayer had the right to deduct depreciation for the year of sale.

	Decision or ruling	Date of profitable sale	Type of property	Tax classification of gain	Relevant allowance for year of sale
14.	Louis Kalb, 15 B.T.A. 865, 866 (1929)	1920	Buildings	Ordinary	Depreciation allowed at rate of 4% per annum to date of sale.
15.	Max Eichenberg, 16 B.T.A. 1368, 1369 (1929)	1922	Building	Capital	Depreciation claimed and allowed for year of sale.
16.	United States v. Farrell, 35 F.2d 38, 39 (D. Conn. 1929)	November 25, 1919	Manufacturing plant	Ordinary	$4,608.80 depreciation claimed and allowed for year of sale.
17.	Franklin Lumber & Power Co., 18 B.T.A. 1207, 1211 (1930), rev'd on other grounds, 50 F.2d 1059 (4th Cir. 1931)	1923	Manufacturing plant	Ordinary	Depreciation claimed and allowed for year of sale.
18.	Herbert Simons, 19 B.T.A. 711, 712-713 (1930)	October 11, 1924	Apartment house	Capital	Commissioner required deduction of depreciation for year of sale and Board of Tax Appeals approved.
19.	Seymour Manufacturing Co. v. Burnet, 56 F.2d 494, 495-496 (D.C. Cir. 1932)	July, 1923	Manufacturing plant	Ordinary	Commissioner computed depreciation for entire period of ownership to date of sale.
20.	Barnett Anchor Oil Co., 25 B.T.A. 746, 749 (1932)	1925	Oil lease	Ordinary	$25,658.79 depletion allowed for year of sale.
21.	C. E. Wentz, Trustee, 26 B.T.A. 868, 869 (1932)	July 28, 1924	Oil and gas leases	Capital	Depletion claimed and allowed for year of sale.
22.	M. Hilty Lumber Co. v. United States, 3 F. Supp. 657, 658 (Ct. Cl. 1933)	May 1, 1919	Sawmill and standing timber	Ordinary	Depletion and depreciation claimed and allowed to date of sale.
23.	C. B. Shaffer, 29 B.T.A. 1315, 1323-1325 (1934)	May 31, 1919	Oil and gas leases	Ordinary	Commissioner conceded that depreciation for January 1 to May 31, 1919 was allowable.
24.	George Blodgett Co. v. Ham, 16 A.F.T.R. 1003 (D. Me. 1934)	1929	Manufacturing plant	Ordinary	Depreciation claimed and allowed for year of sale.
25.	Clark Thread Co., 28 B.T.A. 1128, 1140, 1150-51 (1933), aff'd, 100 F.2d 257 (3d Cir. 1938)	1923	Buildings and machinery	Ordinary	Depreciation allowed for year of sale.
26.	Nocona Cotton Seed Oil Co., 42 B.T.A. 1172, 1175, 1178 (1940)	October 5, 1937	Manufacturing plant	Ordinary	$715.36 of depreciation allowed for year of sale.
27.	Hall v. United States, 43 F. Supp. 130, 131-132 (Ct. Cl.), cert. denied, 316 U. S. 664 (1942)	June 8, 1932	Leaseholds	Capital	Depreciation allowed at rate of 2% per annum to date of sale.

	Decision or ruling	Date of profitable sale	Type of property	Tax classification of gain	Relevant allowance for year of sale
28.	Gunnison Sugar Co. v. Hinckley, 32 A.F.T.R. 1666, 1668 (D. Utah 1942), rev'd, 139 F.2d 492 (10th Cir. 1943)	June 21, 1940	Sugar refinery	Ordinary	Depreciation claimed and allowed for year of sale.
29.	Elizabeth Operating Corp., T. C. Memo. 112709, 2 CCH T. C. Memo. 817, 818 (1943)	January 15, 1940	Hotel	Ordinary	Depreciation claimed and allowed for the first 15 days of 1940 at rate used in prior years.
30.	F. A. Gillespie & Sons Co. v. Commissioner, 154 F.2d 913, 914-915 (10th Cir. 1946)	June 15, 1937	Oil and gas leases	Ordinary	Depreciation and depletion claimed and allowed for year of sale.
31.	Crane v. Commissioner, 331 U.S. 1 (1947)	November 29, 1938	Apartment building	Ordinary	$3,200 of depreciation claimed and allowed for year of sale (3 T.C. 585, 587).
32.	Wier Long Leaf Lumber Co., 9 T.C. 990, 999 (1947), aff'd and rev'd on other issues, 173 F.2d 549 (5th Cir. 1949)	1942	Automobiles	Capital	Tax Court held depreciation was allowable for year of profitable sale.
33.	P. H. & J. M. Brown Co., T.C. Memo. 1959-162, 18 CCH T. C. Memo. 708, 709-710 (1959)	July 1, 1949	Leasehold and improvement	Capital	Depreciation at rate of 2% per annum claimed and allowed to date of sale.
34.	H. L. Gatlin, T. C. Memo. 1960-23, 19 CCH T. C. Memo. 131, 132 (1960)	1953	Livestock	Capital	$505 depreciation allowed for year of sale at profit of $1,035.28.
35.	Massey Motors, Inc. v. United States, 364 U.S. 92 (1960)	1950	Automobiles	Capital	Automobiles depreciated to $1,325 in year of sale for an average of $1,380 (Pet. Br. 21.)
36.	Hertz Corporation v. United States, 364 U.S. 122 (1960)	1954-1956	Automobiles	Capital	Depreciation deducted and allowed for year of profitable sale (Pet. Br. 21-22.)

SUPREME COURT OF THE UNITED STATES

No. 23.—October Term, 1965.

Fribourg Navigation Company, Inc., Petitioner, v. Commissioner of Internal Revenue.	On Writ of Certiorari to the United States Court of Appeals for the Second Circuit.

[March 7, 1966.]

Mr. Chief Justice Warren delivered the opinion of the Court.

The question presented for determination is whether, as a matter of law, the sale of a depreciable asset for an amount in excess of its adjusted basis at the beginning of the year of sale bars deduction of depreciation for that year.

On December 21, 1955, the taxpayer, Fribourg Navigation Co., Inc., purchased the *S. S. Joseph Feuer*, a used Liberty ship, for $469,000. Prior to the acquisition, the taxpayer obtained a letter ruling from the Internal Revenue Service advising that the Service would accept straight line depreciation of the ship over a useful economic life of three years, subject to change if warranted by subsequent experience. The letter ruling also advised that the Service would accept a salvage value on the *Feuer* of $5 per dead-weight ton, amounting to $54,000. Acting in accordance with the ruling the taxpayer computed allowable depreciation, and in its income tax returns for 1955 and 1956 claimed ratable depreciation deductions for the 10-day period from the date of purchase to the end of 1955 and for the full year 1956. The Internal Revenue Service audited the returns for each of these years and accepted the depreciation deductions claimed without adjustment. As a result of these

depreciation deductions, the adjusted basis of the ship at the beginning of 1957 was $326,627.73.

In July of 1956, Egypt seized the Suez Canal. During the ensuing hostilities the canal became blocked by sunken vessels, thus forcing ships to take longer routes to ports otherwise reached by going through the canal. The resulting scarcity of available ships to carry cargoes caused sales prices of ships to rise sharply. In January and February of 1957, even the outmoded Liberty ships brought as much as $1,000,000 on the market. In June 1957, the taxpayer accepted an offer to sell the *Feuer* for $700,000. Delivery was accomplished on December 23, 1957, under modified contract terms which reduced the sale price to $695,500. Prior to the sale of the *Feuer*, the taxpayer adopted a plan of complete liquidation pursuant to the provisions of § 337 of the Internal Revenue Code of 1954, which it thereafter carried out within 12 months. Thus, no tax liability was incurred by the taxpayer on the capital gain from the sale of the ship. As it developed, the taxpayer's timing was impeccable—by December 1957, the shipping shortage had abated and Liberty ships were being scrapped for amounts nearly identical to the $54,000 which the taxpayer and the Service had originally predicted for salvage value.

On its 1957 income tax return, for information purposes only, the taxpayer reported a capital gain of $504,239.51 on the disposition of the ship, measured by the selling price less the adjusted basis after taking a depreciation allowance of $135,367.24 for 357½ days of 1957. The taxpayer's deductions from gross income for 1957 included the depreciation taken on the *Feuer*. Although the Commissioner did not question the original ruling as to the useful life and salvage value of the *Feuer* and did not reconsider the allowance of depreciation for 1955 and 1956, he disallowed the entire depreciation deduction for 1957. His position was sustained by a single

judge in the Tax Court and, with one dissent, by a panel of the Court of Appeals for the Second Circuit. 335 F. 2d 15. The taxpayer and the Commissioner agreed that the question is important, that it is currently being heavily litigated, and that there is a conflict between circuit courts of appeals on this issue. Therefore, we granted certiorari. 379 U. S. 998. We reverse.

I.

The Commissioner takes the position here and in a Revenue Ruling first published the day before the trial of this case in the Tax Court[1] that the deduction for depreciation in the year of sale of a depreciable asset is limited to the amount by which the adjusted basis of the asset at the beginning of the year exceeds the amount realized from the sale. The Commissioner argues that depreciation deductions are designed to give a taxpayer deductions equal to the "actual net cost" of the asset to the taxpayer, and since the sales price of the *Feuer* exceeded the adjusted basis as of the first of the year, the use of the ship during 1957 "cost" the taxpayer "nothing." By tying depreciation to sales price in this manner, the Commissioner has commingled two distinct and established concepts of tax accounting—depreciation of an asset through wear and tear or gradual expiration of useful life and fluctuations in the value of that asset through changes in price levels or market values.

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[1] Rev. Rul. 62-92, 1962-1 Cum. Bull. 29 (originally T. I. R. 384, June 7, 1962). That Ruling provides in part:

". . . the deduction for depreciation of an asset used in the trade or business or in the production of income shall be adjusted in the year of disposition so that the deduction, otherwise properly allowable for such year under the taxpayer's method of accounting for depreciation, is limited to the amount, if any, by which the adjusted basis of the property at the beginning of such year exceeds the amount realized from sale or exchange."

Section 167 (a) of the Internal Revenue Code of 1954 provides, in language substantially unchanged in over 50 years of revenue statutes: "There shall be allowed as a depreciation deduction a reasonable allowance for the exhaustion, wear and tear (including a reasonable allowance for obsolescence)—(1) of property used in the trade or business, or (2) of property held for the production of income." In *United States* v. *Ludey*, 274 U. S. 295, 300–301, the Court described depreciation as follows:

> "The depreciation charge permitted as a deduction from the gross income in determining the taxable income of a business for any year represents the reduction, during the year, of the capital assets through wear and tear of the plant used. The amount of the allowance for depreciation is the sum which should be set aside for the taxable year, in order that, at the end of the useful life of the plant in the business, the aggregate of the sums set aside will (with the salvage value) suffice to provide an amount equal to the original cost."

See also *Detroit Edison Co.* v. *Commissioner*, 319 U. S. 98, 101. In so defining depreciation, tax law has long recognized the accounting concept that depreciation is a process of estimated allocation which does not take account of fluctuations in valuation through market appreciation.[2]

It is, of course, undisputed that the Commissioner may require redetermination of useful life or salvage value when it becomes apparent that either of these factors has been miscalculated. The fact of sale of an asset at an amount greater than its depreciated basis may be

[2] See, *e. g., Macabe Co.*, 42 T. C. 1105, 1109; *Wier Long Leaf Lumber Co.*, 9 T. C. 990, 999, rev'd on other grounds, 173 F. 2d 549; Note, 50 Va. L. Rev. 1431 (1964); Comment, 11 U. C. L. A. L. Rev. 593 (1964). See also Montgomery, Auditing 268 (8th ed. 1957).

evidence of such a miscalculation. See *Macabe Co.*, 42 T. C. 1105, 1115 (1964). But the fact alone of sale above adjusted basis does not establish an error in allocation. That is certainly true when, as here, the profit on sale resulted from an unexpected and short-lived, but spectacular, change in the world market.

The Commissioner contends that our decisions in *Massey Motors, Inc.* v. *United States*, 364 U. S. 92, and *Hertz Corp.* v. *United States*, 364 U. S. 122, confirm his theory. To the extent these cases are relevant here at all, they support the taxpayer's position. In *Massey* and *Hertz* we held that when a taxpayer, at the time he acquires an asset, reasonably expects he will use it for less than its full physical or economic life, he must, for purposes of computing depreciation, employ a useful life based on the period of expected use. We recognized in those cases that depreciation is based on estimates as to useful life and salvage value. Since the original estimates here were admittedly reasonable and proved to be accurate, there is no ground for disallowance of depreciation.

II.

This concept of depreciation is reflected in the Commissioner's own regulations. The reasonable allowance provided for in § 167 is explained in Treas. Reg. § 1.167 (a)–1 as "that amount which should be set aside for the taxable year in accordance with a reasonably consistent plan . . . so that the aggregate of the amounts set aside, plus the salvage value will, at the end of the estimated useful life of the depreciable property, equal the cost or other basis of the property. . . . The allowance shall not reflect amounts representing a mere reduction in market value." Treas. Reg. § 1.167 (a)–1 (c) defines salvage value as the amount, determined at the time of acquisition, which is

estimated will be realizable upon sale or when it is no longer useful in the taxpayer's trade or business. That section continues: "Salvage value shall not be changed at any time after the determination made at the time of acquisition merely because of changes in price levels. However, if there is a redetermination of useful life . . . salvage value may be redetermined based upon facts known at the time of such redetermination of useful life." Useful life may be redetermined "only when the change in the useful life is significant and there is a clear and convincing basis for the redetermination." Treas. Reg. § 1.167 (a)-(1) (b). This carefully constructed regulatory scheme provides no basis for disallowances of depreciation when no challenge has been made to the reasonableness or accuracy of the original estimates of useful life or salvage value. Further, from 1951 until after certiorari was granted in this case, the regulations dealing with amortization in excess of depreciation contained an example expressly indicating that depreciation could be taken on a depreciable asset in the year of profitable sale of that asset.[3]

The Commissioner relies heavily on Treas. Reg. § 1.167 (b)-0 providing that the reasonableness of a claim for depreciation shall be determined "upon the basis of conditions known to exist at the end of the period for which the return is made." He contends that after the sale the taxpayer "knew" that the *Feuer* had "cost" him "nothing" in 1957. This again ignores the distinction between depreciation and gains through market appreciation. The court below admitted that the increase in the value of the ship resulted from circumstances "normally associated with capital gain." The intended interplay of § 167 and the capital gains pro-

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[3] Treas. Reg. § 1.1238-1, Example (1), based on H. R. Rep. No. 3124, 81st Cong., 2d Sess., 29 (1950), amended to conform to the Commissioner's present position on June 1, 1965. 1965-1 Cum. Bull. 366.

visions is clearly reflected in Treas. Reg. § 1.167 (a)-8 (a)(1), which provides:

> "Where an asset is retired by sale at arm's length, recognition of gain or loss will be subject to the provisions of sections 1002, 1231, and other applicable provisions of law."

III.

The Commissioner's position represents a sudden and unwarranted volte-face from a consistent administrative and judicial practice followed prior to 1962. The taxpayer has cited a wealth of litigated cases [4] and several rulings [5] in which the Commissioner unhesitatingly allowed depreciation in the year of favorable sale. Against this array of authority, the Commissioner contends that he did not "focus" on the issue in most of these instances. This is hardly a persuasive response to the overwhelming consistent display of his position. One might well speculate that the Commissioner did not "focus" on the issue in many cases because he treated it as too well settled for consideration. Moreover, in several instances, the Commissioner did not merely consent to depreciation in

[4] See, *e. g.*, *United States* v. *Ludey*, 274 U. S. 295 (1927); *Eldorado Coal & Mining Co.* v. *Mager*, 255 U. S. 522, 526 (1921); *Beckridge Corp.* v. *United States*, 129 F. 2d 318 (C. A. 2d Cir. 1942); *Clark Thread Co.* v. *Commissioner*, 100 F. 2d 257 (C. A. 3d Cir. 1938), affirming 28 B. T. A. 1128, 1140 (1933); *Kittredge* v. *Commissioner*, 88 F. 2d 632 (C. A. 2d Cir. 1937); *Seymour Mfg. Co.* v. *Burnet*, 56 F. 2d 494, 495–496 (C. A. D. C. Cir. 1932); *Hall* v. *United States*, 43 F. Supp. 130, 131–132 (Ct. Cl.), cert denied, 316 U. S. 664 (1942); *Herbert Simons*, 19 B. T. A. 711, 712–713 (1930); *Max Eichenberg*, 16 B. T. A. 1368, 1370 (1929); *Louis Kalb*, 15 B. T. A. 865, 866 (1929); *Evan Realty Co.*, 1 B. T. A. 355, 356 (1925); *H. L. Gatlin*, 19 CCH Tax Ct. Mem. 131, 132 (1960); P. H. & J. M. Brown Co., 18 CCH Tax Ct. Mem. 708, 709–710 (1959).

[5] G. C. M. 1597, VI–1 Cum. Bull. 71 (1927); S. M. 2112, III–2 Cum. Bull. 22 (1924); A. R. R. 6930, III–1 Cum. Bull. 45 (1924); I. T. 1494, I–2 Cum. Bull. 19 (1922). See also I. T. 1158, I–1 Cum. Bull. 173 (1922).

the year of sale, but insisted over the taxpayer's objection that it be taken.[6]

The Commissioner adds that in *Wier Long Leaf Lumber Co.*, 9 T. C. 990, rev'd on other grounds, 173 F. 2d 549, he did focus on the issue and there contended that no depreciation could be taken in the year of sale. However, in *Wier* the Tax Court allowed depreciation as to one class of assets and the Commissioner promptly acquiesced in the decision.[7] 1948-1 Cum. Bull. 3. This acquiescence was not withdrawn until 14 years later when the Commissioner adopted his present position. 1962-1 Cum. Bull. 5. Although we recognize that such an acquiescence does not in and of itself commit the Commissioner to this interpretation of the law, it is a significant addition to the already convincing array of authority showing the Commissioner's consistent prior position.

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[6] In *Herbert Simons, supra, note* 4, the taxpayers tried without success to forgo the depreciation deduction for the year of sale since the taxes payable on the resulting increase in ordinary income would have been less than the increased amount payable under the existing capital gains provision if depreciation were taken. In several other cases the Commissioner expressly required a year-of-sale depreciation deduction, thus increasing the gain on the sale. See, *e. g., Clark Thread Co.* v. *Commissioner, Kittredge* v. *Commissioner, Evan Realty Co., supra,* note 4.

[7] The Commissioner's argument that the decision in *Wier* was ambiguous since the court there disallowed depreciation of another asset in the year of sale is without merit. The court carefully rested its decision disallowing depreciation of that asset on the fact that there was no evidence in the record which would permit it to ascertain reasonable salvage value. With respect to the other class of assets, the court stated:

"The parties have by their stipulation narrowed the scope of controversy. They present for consideration only the question whether the price received from the sale of the depreciated automobile precludes any depreciation allowance." 9 T. C. 990, 999.

The court held: "The depreciation deduction can not be disallowed merely by reason of the price received for the article without consideration of other factors." *Ibid.*

The Commissioner attempts further to explain away the authority aligned against him by stating that most of the cases and rulings prior to 1942 (when capital gain treatment was provided for sales above adjusted basis) are irrelevant since the gain on sale was taxed at the same ordinary income rate that would have been applied had depreciation been disallowed. This contention does not explain away the Commissioner's sudden decision that allowance of such depreciation involves a fundamental error in the basic concept of depreciation. Further, other than his lack of "focus," the Commissioner has had no explanation for those cases in which capital gain on sale *was* involved.[8] Even in those cases before this Court upon which the Commissioner relies for support of his theory, depreciation was willingly allowed in the year of sale. In *Massey Motors, Inc.* v. *United States, supra,* although contesting the useful life of the automobiles involved, the Commissioner allowed depreciation to an estimated value of $1,325 despite sales for an average of $1,380. 364 U. S., at 94–95. And in *Hertz Corp.* v. *United States, supra,* the Commissioner accepted claims of depreciation deductions up to the date of sale, objecting only to the taxpayer's attempt to obtain refunds by changing retroactively to the double declining balance method of depreciation.[9] The fact that there are presently several hundred cases in litigation over this issue where before there were none adds testimony to the inescapable conclusion that the Commissioner has broken with consistent prior practice in espousing the novel theory he now urges upon us.

The authority relied on in Revenue Ruling 62–92, *Cohn* v. *United States,* 259 F. 2d 371, does not support

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[8] See *Hall* v. *United States, Herbert Simons, Max Eichenberg, H. L. Gatlin, P. H. & J. M. Brown Co., supra,* note 4; G. C. M. 1597, VI–1 Cum. Bull. 71 (1927). See also cases cited, note 6, *supra.*

[9] See 165 F. Supp. 261, 265, 269, and Transcript of Record in *Hertz* in this Court, at 13–18.

this departure from established practice. *Cohn* was simply a case in which the taxpayer had assigned no salvage value to the property involved, and the Court of Appeals found no clear error in the selection of the amount realized on disposition of the asset at the end of its scheduled useful life as a reasonable yardstick by which to measure salvage value.[10] As has been aptly stated of *Cohn*, "It does not purport to set up an automatic hindsight re-evalution which becomes a self-executing redetermination of salvage value triggered by the sale of depreciable assets." *Motorlease Corp.* v. *United States*, 215 F. Supp. 356, 363, rev'd, 334 F. 2d 617, pet. for cert. filed. In his brief in *Cohn*, the Commissioner did not rest his case on anything resembling his position here, but relied principally on the fact that the taxpayer himself had sought an adjustment of useful life and that, under the regulations, "if there is a redetermination of useful life, the salvage value may be redetermined." Brief for the United States, pp. 24–26, in *Cohn* v. *United States*, 259 F. 2d 371, quoted in Merritt, Government Briefs in Cohn Refute IRS Disallowance of Year-of-Sale Depreciation, 20 J. Taxation 156, 158 (1964).

IV.

Over the same extended period of years during which the foregoing administrative and judicial precedent was accumulating, Congress repeatedly re-enacted the depreciation provision without significant change. Thus, be-

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[10] Note, for example, the Court's reliance on *Wier Long Leaf Lumber Co.*, discussed in note 7, *supra*. 259 F. 2d, at 378–379. Indeed, the opinion in *Cohn* clearly recognizes the established practice of depreciation which the Commissioner would have us overthrow. The Court there noted:

"Necessarily, salvage value is also an estimate made at the time when the asset is first subject to a depreciation allowance. . . . If the asset is sold at a price in excess of its depreciated value, such excess is taxable in the nature of a capital gain." *Id.*, at 377.

yond the generally understood scope of the depreciation provision itself, the Commissioner's prior long-standing and consistent administrative practice must be deemed to have received congressional approval. See, *e. g.*, *Cammarano* v. *United States*, 358 U. S. 498, 510–511; *United States* v. *Leslie Salt Co.*, 350 U. S. 383, 396–397; *Helvering* v. *Winmill*, 305 U. S. 79, 83.

The legislative history in this area makes it abundantly clear that Congress was cognizant of the revenue possibilities in sales above depreciated cost. In 1942 Congress restored capital gains treatment to sales of depreciable assets.[11] The accompanying House Report stated that it would be "an undue hardship" on taxpayers who were able to sell depreciable property at a gain over depreciated cost to treat such gain as ordinary income. H. R. Rep. No. 2333, 77th Cong., 2d Sess., 54 (1942). This, of course, is *pro tanto* the effect of disallowing depreciation in the year of sale above adjusted basis. It would be strange indeed, especially in light of the House Report, to conclude that Congress labored to create a tax provision which, in application to depreciable property, could by administrative fiat be made applicable only to sales of assets for amounts exceeding their basis at the beginning of the year of sale, and then only to the excess. In succeeding years Congress was repeatedly asked to enact legislation treating gains on sales of depreciated property as ordinary income; [12] it declined to do so until 1962.

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[11] Int. Rev. Code, 1939, § 117 (j), 56 Stat. 846 (now Int. Rev. Code, 1954, § 1231).

[12] See, *e. g.*, Hearings before the House Ways and Means Committee, 80th Cong., 1st Sess., on Revenue Revisions, pt. 5, p. 3756 (1948), at which the Treasury recommended that gains on sales of depreciable assets should be subject to ordinary income taxation to the extent the gains arose from accelerated depreciation; Hearings before the Senate Finance Committee, 83d Cong., 2d Sess., on H. R. 8300, pt. 3, p. 1324 (1954), at which Congress was asked by

In 1961, in his Tax Message to Congress, the President observed that existing law permitted taxpayers to depreciate assets below their market value and, upon sale, to treat the difference as capital gain.[13] The Secretary of the Treasury concurred in this position.[14] The exhibits appended not only contain no mention of the Commissioner's power to require recalculation of depreciation in the year of sale, but refute the existence of such power. In example after example cited by the Treasury, the taxpayer had depreciated an asset, sold it for an amount in excess of its depreciated basis, and treated the difference as capital gain.[15] The Treasury asserted that existing

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the American Institute of Accountants to enact that all gains on sales of depreciable assets be treated as ordinary income. See also Treasury Department Release A-761, February 15, 1960.

[13] The President stated:

"Another flaw which should be corrected at this time relates to the taxation of gains on the sale of depreciable business property. Such gains are now taxed at the preferential rate applicable to capital gains, even though they represent ordinary income.

"This situation arises because the statutory rate of depreciation may not coincide with the actual decline in the value of the asset. While the taxpayer holds the property, depreciation is taken as a deduction from ordinary income. Upon its resale, where the amount of depreciation allowable exceeds the decline in the actual value of the asset so that a gain occurs, this gain under present law is taxed at the preferential capital gains rate. The advantages resulting from this practice have been increased by the liberalization of depreciation rates. . . .

"I therefore recommend that capital gains treatment be withdrawn from gains on the disposition of depreciable property, both personal and real property, to the extent that depreciation has been deducted for such property by the seller in previous years, permitting only the excess of the sales price over the original cost to be treated as a capital gain." Message on Taxation, Hearings before the Committee on Ways and Means, House of Representatives, H. R. Doc. No. 140, 87th Cong., 1st Sess., 11 (1961).

[14] *Id.*, at 40.

[15] *Id.*, at 262-267. See also Treas. Reg. § 1.1238-1, note 3, *supra*.

law permitted this practice, and made no mention of the power which the Commissioner now alleges he possesses to disallow year-of-sale depreciation.

In 1962 Congress enacted § 1245 of the Internal Revenue Code of 1954, providing that gain on future dispositions of depreciable personal property be treated as ordinary income to the extent of depreciation taken. For post-1962 transactions § 1245 applies to the situation which occurred in the instant case and would produce greater revenue. The taxpayer must report as ordinary income *all* depreciation recouped on sale, and this notwithstanding that the sale was part of a nonrecognition liquidation within § 337. In 1964, a more complex recapture provision dealing with real property was enacted. This time, however, Congress took into account the fact that increases in the value of real property are often attributable to a rise in the general price level and limited recapture of depreciation as ordinary income to a percentage of the excess over straight line depreciation. H. R. Rep. No. 749, 88th Cong., 1st Sess., 101–102 (1963); S. Rep. No. 830, 88th Cong., 2d Sess., 132–133 (1964).[16] The Commissioner's position would ignore any such limitation. Compounding congressional activity in this area with repeated re-enactment of the depreciation provision in the face of the prior consistent administrative practice, we find the Commissioner's position untenable.

[16] In 1963, with the instant case already in the courts, Congress for the first time alluded to the position now taken by the Commissioner, noting that:

". . . it has been held that depreciation deductions should not be allowed to the extent they reduce the adjusted basis of the property below the actual amount realized. This provision, in providing for ordinary income treatment for certain additional depreciation, is not intended to affect this holding." H. R. Rep. No. 749, 88th Cong., 1st Sess., 103 (1963); S. Rep. No. 830, 88th Cong., 2d Sess., 133 (1964).

V.

Finally, the Commissioner's position contains inconsistencies. He contends that depreciation must be disallowed in 1957 since the amount received on sale shows that the use of the asset "cost" the taxpayer "nothing" in that year. But under this view, since the asset was sold at an amount greater than its original purchase price, it "cost" the taxpayer "nothing" in 1955 and 1956 as well. The Commissioner's reliance on the structure of the annual income tax reporting system does not cure the illogic of his theory. Further, the Commissioner apparently will not extend his new theory to situations where it would benefit the taxpayer. If a depreciable asset is sold for *less* than its adjusted basis, it would seem to follow from the Commissioner's construction that the asset has "cost" the taxpayer an additional amount and that further depreciation should be permitted. However, Revenue Ruling 62–92 does not extend to such a case and the Commissioner has expressly refused to do so.[17]

The conclusion we have reached finds support among nearly all lower federal courts that have recently dealt with this issue.[18] Upon consideration *en banc*, the Tax

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[17] In *Engineers Limited Pipeline Co.,* 44 T. C. 226 (1965), the taxpayer contended that he should get a further depreciation deduction on assets which he sold for less than their depreciated basis. The Commissioner disallowed the additional deduction. See also *Whitaker* v. *Commissioner,* 259 F. 2d 379.

[18] See *United States* v. *S & A Co.,* 338 F. 2d 629 (C. A. 8th Cir.), affirming 218 F. Supp. 677 (D. C. D. Minn.), pet. for cert. filed; *Occidental Loan Co.* v. *United States,* 235 F. Supp. 519 (D. C. S. D. Calif.); *Wyoming Builders, Inc.* v. *United States,* 227 F. Supp. 534 (D. C. D. Wyo.); *Motorlease Corp.* v. *United States,* 215 F. Supp. 356 (D. C. D. Conn.), reversed on the authority of the decision below in the instant case, 334 F. 2d 617 (C. A. 2d Cir.), pet. for cert. filed; *Mountain States Mixed Feed Co.* v. *United States,* 245

Court itself has concluded that the Commissioner's position is without authorization in the statute or the regulations.[19]

In light of the foregoing, we conclude that the depreciation claimed by the taxpayer for 1957 was erroneously disallowed.

Reversed.

F. Supp. 369 (D. C. D. Colo.). See also *Kimball Gas Products Co. v. United States*, 63–2 USTC ¶ 9507 (D. C. W. D. Tex.). Contra, *Killebrew* v. *United States*, 234 F. Supp. 481 (D. C. E. D. Tenn.).

[19] *Macabe Co.*, 42 T. C. 1105 (1964). The attempt in *Macabe* to distinguish the instant case on the ground that here the taxpayer used inaccurate estimates and failed to sustain its burden of proof of market appreciation ignores the fact that the Commissioner does not contest the reasonableness of the original estimates of useful life and salvage value. See McNerney, Disallowance of Depreciation in the Year of Sale at a Gain, 20 Tax L. Rev. 615, 650 (1965).

SUPREME COURT OF THE UNITED STATES

No. 23.—October Term, 1965.

Fribourg Navigation Company, Inc., Petitioner, *v.* Commissioner of Internal Revenue.	On Writ of Certiorari to the United States Court of Appeals for the Second Circuit.

[March 7, 1966.]

Mr. Justice White, with whom Mr. Justice Black and Mr. Justice Clark join, dissenting.

In my opinion, the Court of Appeals was faithful to the congressional concept of depreciation and to the Internal Revenue Code and applicable Treasury Regulations. Accordingly, I would affirm.

Section 167 (a) of the Internal Revenue Code of 1954 authorizes as a depreciation deduction only a *"reasonable* allowance" for exhaustion, wear and tear, and obsolescence. (Emphasis added.) This allowance was designed by Congress to enable the taxpayer to recover his net investment in wasting assets used in his trade or business or held for the production of income to the extent that the investment loses value through exhaustion, wear and tear, or obsolescence.[1] In this manner the tax-

[1] The House Report on the 1954 Internal Revenue Code has defined depreciation as "allowances [whereby] *capital invested in an asset* is recovered tax-free over the years it is used in business." H. R. Rep. No. 1337, 83d Cong., 2d Sess. p. 22. (Emphasis added.) Similarly, in *Virginian Hotel Co.* v. *Helvering,* 319 U. S. 523, the Court discussed depreciation in terms of an amount "which, along with salvage value, will replace the original investment of the property. . . ." This Court has, on other occasions, spoken of depreciation in terms of a gradual sale of the depreciable asset as it is physically used up year by year in the trade or business. See *Massey Motors* v. *United States,* 364 U. S. 92, 104. However, this is to say the same thing in different words. Even if one views depreciation as

payer will be taxed only on the net, rather than the gross, income produced by the depreciable asset in accordance with the general congressional scheme to tax only net income. It was not, however, the intent of Congress to enable the taxpayer to recover more than his actual net investment and thereby to convert ordinary income into a capital gain through excessive depreciation. "Congress intended by the depreciation allowance not to make taxpayers a profit thereby, but merely to protect them from a loss." *Massey Motors* v. *United States,* 364 U. S. 92, 101. See also *Detroit Edison* v. *Commissioner,* 319 U. S. 98, where the Court refused to allow the taxpayer to depreciate that portion of the initial investment of an asset that did not represent actual expenditure by it because borne by its customers. Accordingly, in judging whether a given depreciation deduction is "reasonable," we should determine whether the deduction is designed to recover tax-free only the actual investment in the asset, *Massey Motors, supra,* at 105, or whether it is calculated instead to return a greater amount.

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representative of the physical exhaustion of an asset, it is not measured in terms of nuts and bolts but in terms of the "financial consequences to the taxpayer of the subtle effects of time and use on . . . his capital asset." *Detroit Edison Co.* v. *Commissioner,* 319 U. S. 98, 101. Investment is not to be measured in terms of original or initial cost, but in terms of "net investment," *Detroit Edison Co.* v. *Commissioner, supra,* at 103, or "actual cost," *Massey Motors* v. *United States, supra,* at 106. Accordingly, salvage value, Treas. Reg. § 1.167 (a)-1, and other reimbursements received by the taxpayer, *Detroit Edison Co.* v. *Commissioner, supra,* must be deducted from the taxpayer's initial investment in the asset in order to arrive at a depreciable "net investment." I use the word "investment" rather than "cost" because "cost" may have so many different meanings, both to the accountant and to the tax lawyer, and some of those meanings would do considerable violence to the congressional purpose for depreciation allowances.

It would be easy enough to compute depreciation if the taxpayer were required to wait until disposition of the asset, at which time he would know with precision his net investment, before he could claim a depreciation allowance. Whether he were then required to take the entire depreciation allowance in the year of sale or permitted to reopen the previous tax years during which he held the asset and spread the allowance ratably among them, it could be ensured that he would then recover precisely, but no more than, his actual, net investment. However, both for administrative and economic reasons, Congress has chosen to allow the taxpayer to take depreciation deductions in advance of the disposition of the asset by estimating what portion of his net investment should be allocated for the use of the asset in any given year. This estimate involves two unknowns: the duration of its use by the taxpayer [2] and the salvage value (resale price of the asset if it is resold).[3] Every effort must be made, in estimating these two values, to come as close to the actual figures as possible. *Massey Motors* v. *United States, supra.* Indeed, it is reasonable to use

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[2] Useful life is to reflect the realities of the taxpayer's actual experience rather than a possibly unrealistic conceptualized idea of inherent physical life. *Massey Motors* v. *United States, supra,* n. 1.

[3] As is the case with useful life, salvage value should reflect the actualities of the situation. When a depreciated asset is sold the economic reality is that the resale price is the salvage value. This practical definition of salvage value was clearly contemplated in *Massey Motors, supra,* n. 1, where the Court talked in terms of "real salvage *price*" and "*resale*" value. *Id.*, at 105, 107. (Emphasis added.) In *Hertz Corp.* v. *United States,* 364 U. S. 122, 127, the Court spoke in terms of "the price that will be received when the asset is retired." See also Treas. Reg. § 1.167 (a)-1 (c), which speaks in terms of an amount "realizable upon sale . . . of an asset when it is no longer useful in the taxpayer's trade or business or in the production of his income. . . ."

estimates at all only because the actual figures are generally not knowable in advance. However, when the actual figures do become known and they differ materially from the estimates of them previously made and they can be substituted for the estimates with almost no inconvenience or unfairness, then it seems to me to be clearly unreasonable, and hence unauthorized by § 167, to continue to rely on the estimates. See *Hertz Corp.* v. *United States, supra,* at 128.

In the present case, Fribourg knew in 1957 what its actual net investment in the *S. S. Joseph Feuer* would be. It knew that if it claimed the previously estimated depreciation deduction for that year it would recover more than its net investment and would be immunizing other income from normal income tax rates.[4] It also knew that a readjustment could be made for 1957 with finality and without significant inconvenience because the resale value and useful life had been definitely determined. Nevertheless, Fribourg continued to use the previously estimated figures, known to it to be erroneous. This, to me, was patently unreasonable and, therefore, outside the scope of § 167.

Not only did Fribourg violate the terms of the statute, it also failed to comply with the applicable, long-standing Treasury Regulations. Treasury Regulation § 1.167(a)-1 (b) provides that the estimate of useful life is to be

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[4] It is in this economic sense that the Commissioner means that it "cost" Fribourg nothing to use the *S. S. Joseph Feuer* in 1957. Obviously the ship suffered some physical wear and tear during use in 1957. But measured in economic terms Fribourg had already been compensated in advance for that wear and tear as it affected its net investment in the ship because excessive depreciation deductions had been taken in the earlier years. The Commissioner is asking now only that Fribourg be prevented from deliberately compounding the error innocently made in earlier years by continuing to claim depreciation deductions after it knew its entire net investment in the *S. S. Joseph Feuer* had already been recovered.

redetermined by reason of conditions known to exist at the end of the taxable year whenever the change in useful life is significant and there is a clear and convincing basis for the redetermination. As a companion provision, Treas. Reg. § 1.167 (a)–1 (c) provides that whenever there is a redetermination of useful life, salvage value should also be redetermined if required by facts known at the time of the redetermination. At the end of the taxable year 1957, Fribourg knew it had overestimated useful life by approximately one-third, which seems to me to be a significant error. At the same time, it knew its estimate of salvage value was only about one-thirteenth the actual salvage value. And, it had the clearest and most convincing basis possible for redetermination—it knew the actual figures. As I read the above regulations, they surely require a redetermination in this situation.

Further, Treas. Reg. § 1.167 (b)–0 says that "deductions for depreciation shall not exceed such amounts as may be necessary to recover the unrecovered cost or other basis less salvage. . . ." To the same effect are Treas. Reg. §§ 1.167 (a)–1 (a) and (c), which warn that "an asset shall not be depreciated below a reasonable salvage value," remembering that reasonableness is to be determined "upon the basis of conditions known to exist at the *end of the period for which the return is made.*" Treas. Reg. § 1.167 (b)–0. (Emphasis added.) See *Hertz Corp.* v. *United States, supra.* Yet here Fribourg knowingly recovered more than its "cost or other basis" less salvage. Here Fribourg knowingly depreciated its asset below a reasonable salvage value in light of conditions known at the end of 1957.

I think the majority misreads that provision in the regulations that says "Salvage value is the amount (determined at the time of acquisition) which is estimated will be realizable upon sale or other disposition of

an asset . . . . Salvage value shall not be changed at any time after the determination made at the time of acquisition merely because of changes in price levels." Treas. Reg. § 1.167 (a)–1 (c). That provision merely recognizes the fact that in years prior to the concluding of a resale agreement the salvage value can only be estimated and it would be administratively burdensome and frequently futile to require redeterminations each year merely because of price changes that may ultimately prove ephemeral. But those provisions certainly do not express a policy against redetermination, in the year of a premature sale, of salvage value when it can be known with finality what effect the price levels will have on the salvage value. Rev. Rule 62–92, 1962–1 Cum. Bull. 29; *Cohn* v. *United States,* 259 F. 2d 371, 378. The very next sentence in that regulation seems to acknowledge the relevance of price levels, provided that such recognition does not cause undue administrative hardship: "However, if there is a redetermination of useful life . . . , salvage value may be redetermined based upon facts known at the time of such redetermination of useful life."

The majority opinion faults the Commissioner for having "commingled two distinct . . . concepts of tax accounting—depreciation of an asset through wear and tear or gradual expiration of useful life and fluctuations in the value of that asset through changes in price levels or market values." In my opinion these two concepts, as used in the Internal Revenue Code, are necessarily commingled and it is unrealistic to expect that one can be isolated from the other. One of the essential elements in the concept of depreciation deductions is salvage value, Treas. Reg. § 1.167 (a)–1 (a); salvage value is resale price if the asset is resold, *Massey Motors* v. *United States, supra,* at 105–107; *Lane* v. *Commissioner,* 37 T. C. 188; and resale price is directly influenced by fluc-

tuations in market value. To the extent that such fluctuations are predictable, they must be considered in making a reasonable estimate of salvage or resale value of the investment. See *Bolta Co.* v. *Commissioner*, 4 CCH Tax Ct. Mem. 1067.[5] In addition, as reflected by this case, predictable market fluctuations in value may also affect the useful life of the asset. To the extent that disposal of an asset by sale becomes more attractive through market appreciation it can be expected that useful life, as defined in *Massey Motors, supra,* will shorten. Although market appreciation in this case was more rapid than will normally be the case, it was predictable for more than a year before Fribourg sold its ship, and by the end of 1957 Fribourg knew exactly what effect market appreciation would have upon the resale value of useful life. In this situation market appreciation should not have been disregarded.

The majority also contends that the Commissioner's position contains an inconsistency because he disallowed depreciation only for the year in which the sale occurred and did not require a disallowance for previous years although the resale price was sufficiently high to indicate that the *S. S. Joseph Feuer* did not "cost" Fribourg anything in the earlier years either. However, in the earlier tax years it was reasonable to rely on the estimated salvage value, since the actual salvage value was not then known. At any rate, it is well established that a modification of the depreciation allowance (for whatever reason) will not be applied retroactively to previous tax years. For example, if the useful life is determined to be longer than originally believed, the allowable depre-

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[5] The Tax Court's current position on the relevance of predictable market appreciation at the time of a determination of useful life and salvage value is not entirely clear. Compare *Smith Leasing Co.* v. *Commissioner*, 43 T. C. 37, with *Macabe Co., Inc.* v. *Commissioner*, 42 T. C. 1105.

ciation is not modified for the prior years in which excessive depreciation had been taken, but the remaining undepreciated basis minus salvage value is spread ratably over the new estimated remaining useful life and depreciation deductions taken accordingly for the current and succeeding years. *Commissioner* v. *Cleveland Adolph Mayer Realty Corp.*, 160 F. 2d 1012; *Commissioner* v. *Mutual Fertilizer*, 159 F. 2d 470; 4 Mertens, Law of Federal Income Taxation, § 23.47; see also *Virginian Hotel* v. *Helvering*, 319 U. S. 523; S. Rep. No. 665, 72d Cong., 1st Sess., 29.

There is a further alleged inconsistency because the Commissioner may be refusing to allow additional depreciation in the year of sale when salvage value turns out to be less than the adjusted basis at the time of sale. This alleged inconsistency, however, should be dealt with when it is properly presented to us.[e]

Finally, I turn to the majority's contention that the Commissioner's position represents a dramatic departure from previous administrative and judicial practice and that congressional re-enactment of the depreciation provision during this time reflects congressional approval of that previous interpretation.

Several of the cases and revenue rulings relied upon by the majority to establish past practice were concerned with tax years previous to 1922,[f] when the first capital

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[e] Similarly, because our situation involves appreciated market values, we are not now concerned with that sentence in Treas. Reg. § 1.167 (a)-1 (a) that reads, "The allowance shall not reflect amounts representing a mere reduction in market value." At any rate, this sentence merely reflects the congressional intent that a taxpayer be permitted to recover his net investment in an asset to the extent that the net investment represents "exhaustion, wear and tear [or] obsolescence."

[f] Of the rulings cited in n. 5 of the majority opinion, only one, G. C. M. 1597, VI-I Cum. Bull. 71 (1927), involved a tax year after 1921. Both Supreme Court cases cited in n. 4 of the majority

gain provision became applicable.[8] I would not give precedential significance to positions taken during that time because the tax saving resulting from a depreciation deduction in the year of sale would have been exactly offset by the tax liability resulting from the correspondingly greater gain upon the sale of the asset due to the lower basis. The remaining revenue ruling[9] and most of the remaining cases relied upon by the majority were concerned primarily with issues other than the one now before us.[10] In the absence of any indication that the Commissioner or the courts in those instances focused on the precise issue now before us these examples are without precedential value. There is one early decision of the Board of Tax Appeals, *Simons* v. *Commissioner*, 19 B. T. A. 865, and one by the Tax Court, *Wier Long Leaf Lumber Co.*, 9 T. C. 990, that did expressly consider the problem whether a taxpayer could claim depreciation in the year he sells an asset at a price above his depreciated basis for that asset. In *Wier Long Leaf Lumber Co.* the Commissioner challenged the right of the taxpayer to take depreciation in the year of sale and at least part of that court's opinion seems to support the Commis-

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opinion, *United States* v. *Ludey*, 274 U. S. 295, and *Eldorado Coal & Mining Co.* v. *Mager*, 255 U. S. 522, were concerned with tax years prior to 1922. Similarly, *Louis Kalb*, 15 B. T. A. 865, and *Evan Realty Co.*, 1 B. T. A. 355, involved tax years prior to 1922.

[8] 42 Stat. 227, § 206 (a).

[9] G. C. M. 1597, VI-I Cum. Bull. 71 (1927). See also Treas. Reg. § 1.1238-1, Example 1, which was designed to show the interaction between §§ 168 and 1238, not the allowance of depreciation of § 167. That example has now been retroactively amended to the date of its original adoption in 1951. T. D. 6825, 1965-1 Cum. Bull. 366.

[10] *Beckridge Corp.* v. *United States*, 129 F. 2d 318; *Clark Thread Co.* v. *Commissioner*, 100 F. 2d 257; *Kittredge* v. *Commissioner*, 88 F. 2d 632; *Seymour Mfg. Co.* v. *Burnett*, 56 F. 2d 494; *Hall* v. *United States*, 43 F. Supp. 130; *Eichenberg* v. *Commissioner*, 16 B. T. A. 1368; *H. L. Gatlin*, 19 CCH Tax Ct. Mem. 131; *P. H. & J. M. Brown Co.*, 18 CCH Tax Ct. Mem. 708.

sioner's position.[11] This leaves only *Simons* v. *Commissioner* in which the Commissioner and the Board appear to take a considered position inconsistent with that now urged by the Commissioner. In my opinion that decision should be disapproved as being inconsistent with the statutory provision for depreciation and the interpretative regulations. In recent years, it should be observed, there is substantial judicial authority for the disallowance of depreciation in the year of a sale above depreciated basis.[12]

To the extent that the Commissioner took an inconsistent position in any of these early cases, I would certainly not now hold him to that position.[13] We have frequently in the past recognized the Commissioner's authority to re-evaluate a prior position upon the basis of greater experience and reflection and to adjust that position to the extent that he becomes convinced that an adjustment is necessary to comport with congressional intent, even when this results in a distinct reversal of a previous position and the taxpayer had relied upon the previous position.[14] *Dixon* v. *United States,* 381 U. S.

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[11] See also *Duncan-Homer Realty Co.* v. *Commissioner,* 6 B. T. A. (1927), where the Board of Tax Appeals sustained the Commissioner's refusal to allow depreciation in the year of a profitable sale.

[12] *Fribourg Navigation Co., Inc.,* v. *Commissioner,* 335 F. 2d 15; *United States* v. *Motorlease Corp.,* 334 F. 2d 617, pet. cert. filed; *Cohn* v. *United States,* 259 F. 2d 371; *Killebrew* v. *United States,* 234 F. Supp. 481.

[13] The Commissioner's acquiescence in *Wier Long Leaf Lumber* Co., 9 T. C. 990, can have no clearer significance than has the opinion itself, with its arguably inconsistent holdings. At any rate, at the front of each cumulative bulletin it is clearly explained that acquiescenses "have none of the force or effect of Treasury Decisions and do not commit the Department to any interpretation of the law." See *Dixon* v. *United States,* 381 U. S. 68.

[14] See 26 U. S. C. § 7805, which gives authority to the Secretary of the Treasury or his delegate to "prescribe all needful rules and

68; *Automobile Club of Michigan* v. *Commissioner*, 353 U. S. 180. Were the Commissioner denied this authority, it would be tantamount to freezing in acknowledged error. It seems strange, therefore, that the majority today would deny the Commissioner this authority when his earlier position was not clear and when Fribourg has made absolutely no showing that it would not have made arrangements to sell the *S. S. Joseph Feuer* when it did but for a reliance upon the alleged previously inconsistent position of the Commissioner.

Under these circumstances, it also seems unrealistic to me to argue that, by re-enacting the depreciation provision on several occasions prior to the promulgation of Rev. Rule 62–92 in 1962, Congress intended to give force of statutory law to the position that depreciation should be allowed on an asset in the year it is sold at a price above its depreciated basis. This reasoning has been recognized as "no more than an aid in statutory construction," *Helvering* v. *Reynolds*, 313 U. S. 428, 432, and as "an unreliable indicium at best" by THE CHIEF JUSTICE writing for the Court in *Commissioner* v. *Glenshaw Glass Co.*, 348 U. S. 426, 431. It is a particularly unreliable aid in statutory construction unless the previous interpretation had been clearly and officially promulgated and Congress had been specifically advised of that interpretation in connection with the re-enactment of the relevant statutory provision. *Higgins* v. *Commissioner*, 312 U. S. 212; see generally, 1 Davis, Administrative Law Treatise, § 5.07. Here there was no official

regulations . . . , including all rules and regulations as may be necessary by reason of any alteration of law in relation to internal revenue." Subsection (b) of that section says "The Secretary or his delegate may prescribe the extent, if any, to which any ruling or regulation, relating to the internal revenue laws, shall be applied without retroactive effect."

Treasury Regulation or Treasury Decision clearly articulating the theory that depreciation should be allowed in the year of profitable sale. Indeed, as indicated earlier, the relevant Treasury Regulations seemed generally to indicate quite the opposite conclusion. Nor is there any indication that anyone asserted to Congress during a time that it was considering re-enactment of the depreciation provision that the Commissioner had embraced a position that depreciation had to be allowed on property in the year that it was sold at a price in excess of its adjusted basis. The legislative history and various requests made to Congress upon which the majority relies were directed to the capital-gain provisions of the Code, not the depreciation provision. And, there are indications that Congress intended to treat the two provisions separately. See H. R. Rep. No. 749, 88th Cong., 1st Sess., 103 (1963); S. Rep. No. 830, 88th Cong., 2d Sess., 133 (1964). For example, the "undue hardship" which prompted Congress to enact § 1231 was no doubt the hardship of paying tax on gain resulting from many years of appreciation when all of the gain is bunched into the year of sale. The Commissioner's refusal to allow depreciation in the year of profitable sale is in no way inconsistent with this attempt by Congress to alleviate hardships resulting from the bunching of income. Further, the fact that Congress was asked in the President's 1961 Tax Message to enact legislation treating gain upon the sale of depreciated property as regular income to the extent that the property had previously been depreciated should not be construed as a representation to Congress that the Commissioner did not have the authority he now claims. That recommendation was generally concerned with excessive depreciation in years "previous" to the year of sale, an abuse that the Commissioner has never claimed to be able to correct without congressional assistance. None of the examples cited to Congress in this

Message are inconsistent with the Commissioner's authority to deny depreciation in the year of profitable sale.[15]

In 1962 and again in 1964 Congress enacted certain recapture provisions.[16] These provisions indicate a congressional attitude, consistent with the Commissioner's position, that depreciation should not exceed actual, net investment and that excessive depreciation should not be permitted to convert ordinary income into capital gain. The only concrete evidence that Congress was really aware of the Commissioner's position that depreciation should be disallowed in the year of profitable sale is to be found in the House and Senate Reports considering § 1250, the recapture provision dealing with depreciable real estate. I think the comments contained in those Reports on the position taken by the Commissioner are highly relevant:

> "[T]he enactment of this provision is not intended to affect the question of whether all or any part of a claimed deduction is in fact allowable. For example, since in the year real property is sold the actual value of the property is known, it has been held that depreciation deductions should not be allowed to the extent they reduce the adjusted basis of the property below the actual amount realized. This provision, in providing for ordinary income treatment for certain additional depreciation, *is not intended to affect this holding.*" H. R. Rep. No. 749, 88th Cong., 1st Sess., p. 103 (1963); S. Rep. No. 830, 88th Cong., 2d Sess., p. 133 (1964). (Emphasis added.)

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[15] Similarly, the other requests addressed to Congress mentioned in the majority opinion were concerned with problems beyond the remedial power of the Commissioner to disallow depreciation in the year of profitable sale.

[16] 26 U. S. C. §§ 1245, 1250.

Congress gave to the Secretary of the Treasury or his delegate, not to this Court, the primary responsibility of determining what constitutes a "reasonable" allowance for depreciation. When the Commissioner adopts a rational position that is consistent with the purpose behind the depreciation deduction, congressional intent, and the language of the statute and interpretative Treasury Regulations, I would affirm that position.

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